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No. .....

IN THE

# Supreme Court of the United States

October Term, 1982

CAROL SMITH SHANNON and PHILIP A. TOFT,

*Petitioners,*

*vs.*

FRED H. HARMSEN, *et al.*,

*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

## PETITION FOR WRIT OF CERTIORARI.

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## QUESTIONS PRESENTED.

Following a jury trial in the United States District Court, Southern District of California, petitioners Carol Smith Shannon and Philip A. Toft were found liable for millions of dollars in damages under various theories in a class action arising from the failure of the United States National Bank of San Diego, an entity formerly connected with C. Arnholt Smith, who was the controlling shareholder of the Bank and a director and officer. Although neither Carol Smith Shannon nor Philip A. Toft had ever been an officer or director of United States National Bank, they were named in a class action, purportedly brought on behalf of the shareholders of the Bank, which alleged liability under the National Bank Act, the federal securities laws and pendent state claims for fraud and breach of fiduciary duty. Prior to trial, the district court dismissed the claims under the National Bank Act as to Shannon and Toft and all other defendants who were not directors of the Bank and no appeal was taken from this dismissal. Furthermore, at conclusion of the trial, the question of substantive violations by Shannon and Toft of the federal securities laws was not submitted to the jury. Instead, questions of alleged indirect violation of §10(b) of the Securities Exchange Act, as aiders and abettors and co-conspirators, were submitted as to both Shannon and Toft, and, with respect to Shannon, further charges of indirect violation under §10(b) as a controlling person were also submitted. In addition, pendent state causes of action of fraud, conspiracy to defraud, and conspiracy to abuse control were also submitted to the jury. On appeal by petitioners, the Court of Appeals upheld the judgment against petitioners. The questions presented by this petition are:

(1) Whether the National Bank Act, in providing the exclusive remedy in this class action, precluded the class plaintiffs' claims for relief under §10(b) and the pendent state causes of action;

(2) Whether the plaintiff class was properly certified and whether the plaintiffs had standing to bring a class action under §10(b) and the pendent state causes of action; and

(3) Whether the decision of the Court of Appeals has erroneously expanded secondary liability under §10(b), when petitioners, who were never officers or directors of the Bank, lacked any duty to inform the Bank's shareholders of the Bank's financial condition and, further, lacked the *scienter* necessary to establish a violation under §10(b).

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## PETITION FOR WRIT OF CERTIORARI.

Petitioners Carol Smith Shannon ("Shannon") and Philip A. Toft ("Toft") respectfully pray that a Writ of Certiorari be issued to review the December 1, 1982 opinion of the United States Court of Appeals for the Ninth Circuit.[1] That opinion determined, *inter alia*, that (1) notwithstanding the preemptive provisions of Section 93 of the National Bank Act, the Act does not provide the exclusive remedy and, thus, does not prevent the imposition of liability under §10(b) of the Securities Exchange Act of 1934 and pendent state causes of action; (2) indirect or secondary liability under §10(b) may apply to the individuals in a class action certified not on behalf of purchasers or sellers of stock, but rather on behalf of "shareholders who were beneficial owners"

[1]The case below was a class action brought against several defendants. The matter went to trial against petitioners as well as against C. Arnholt Smith, his wife Helen Smith, his brother John Smith and First National Finance Corporation and M.J. Coen. Three other defendants defaulted.

In addition to the points raised in this petition, petitioners further incorporate the arguments contained in the separate petition of Helen Smith, which is also being filed in this matter.

of the stock; and (3) the imposition of indirect or secondary liability under §10(b) and pendent state theories is proper despite the fact that individuals, such as petitioners, were neither officers nor directors of the corporate entity and had no duty of disclosure or the requisite *scienter*.

**OPINION BELOW.**

The decision of the Court of Appeals of which petitioners seek review is reported at 693 F.2d 932; a copy is appended hereto as Appendix A. The Court of Appeals decided an earlier interlocutory appeal in this case, commonly known as *Harmsen I*, which is reported at 542 F.2d 496.

**JURISDICTION.**

The Court of Appeals' decision was filed on December 1, 1982. On January 14, 1983, petitioners filed a petition in the Court of Appeals for rehearing, with the suggestion that the rehearing be *en banc*. On March 3, 1983, the Court of Appeals denied petitioners' petition for rehearing, and on March 11, 1983, petitioners filed in the Court of Appeals a motion to stay the mandate for 90 days, pending an appropriate Petition for Writ of Certiorari in this Court. On April 1, 1983, the Court of Appeals granted petitioners' motion to stay the mandate to and including June 1, 1983, so that this Petition for Writ of Certiorari could be filed. As a result, this Petition is being filed within the time permitted by the Court of Appeals and within the time permitted by 28 U.S.C. §2101. This Court has jurisdiction to review the Court of Appeals' decision by Writ of Certiorari pursuant to 28 U.S.C. §1254(1).

**STATUTORY PROVISIONS INVOLVED.**

The provisions involved are:

1. Section 93 of the National Bank Act, 12 U.S.C. §93. (Appendix B.)

2. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b). (Appendix C.)

## STATEMENT OF THE CASE.

### A. Summary of Basic Facts.

From 1933 until 1973, C. Arnholt Smith controlled United States National Bank ("USNB"). During this period he also formed and controlled a number of other corporations to which USNB provided significant financing. In many instances the extent of financing provided to these firms exceeded the limits set by federal regulations. In addition, during the tight money period occurring at the close of the 1960s loans were made to one corporation for a stated purpose and actually used by one or more other Smith controlled corporations to repay loans which came due at USNB. These practices, engaged in by USNB with the active or tacit concurrence of the directors, were under observation by the Comptroller of the Currency.

Shannon is Smith's daughter. Together with Smith's former wife Lois Smith, Shannon owned United States Holding Company. Shannon also owned and operated Valley Lane Farms, Inc. and its subsidiary, Underwriters Insurance Agency. Subsequent to March 1, 1971, Shannon secured loans from USNB for Underwriters Insurance Agency and Valley Lane Farms. The money loaned to Underwriters Insurance Agency was reloaned to another Smith controlled entity, and later repaid. There is no evidence in the record to suggest that Shannon acted in privity with any other nondirector defendant in the actions described above. The arrangements were between her and her father.

In 1968 Toft was an officer and director of Westgate-California Corporation. Subsequent to March 1, 1968, Toft secured loans for Westgate's subsidiaries. On some occasions at Smith's suggestion the money was reloaned to an-

other Smith controlled entity. There is no evidence in the record to suggest that Toft acted in privity with any other nondirector defendant in the actions described above. The arrangements were between Toft and Smith. All such loans to Westgate's subsidiaries were repaid.

**B. Nature of the Case.**

On October 18, 1973, the Comptroller of the Currency declared USNB insolvent and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver. A few days later a class action complaint was filed in the United States District Court for the Southern District of California on behalf of one Fred H. Harmsen, who purported to act for some four thousand shareholders of USNB. At about the same time a similar class action was filed in the Central District of California on behalf of Ken Hansen and two other individuals who also purported to act on behalf of the shareholders of USNB.

In due course the two cases were consolidated in the Southern District of California and, after somewhat prolonged pretrial proceedings, the case went to trial on August 16, 1979. At this time the Third Amended Consolidated Complaint was in effect. It alleged five separate categories of claims: First — under the National Bank Act; Second — under the Federal Securities Laws; Third — under the California Corporations Code; Fourth — under pendent jurisdiction for abuse of control; and Fifth — under pendent jurisdiction for fraud.

The named defendants were in three categories: A) officers and directors of USNB; B) corporations doing business with USNB; and C) officers and directors of corporations doing business with USNB. Smith was in category A and Shannon and Toft were in category C.

The Third Amended Consolidated Complaint alleged in paragraph 10 that the "[d]efendant directors engaged in improper activities which caused the Comptroller of Currency of the United States on October 18, 1973 to declare the USNB insolvent." These alleged activities were set forth in the ensuing paragraphs (paragraphs 10 through 12) and purport to be the activities on which the First Claim was based. The activities alleged in paragraphs 10 through 12 were incorporated by reference in the ensuing claims and those claims were purported to be based on the same director activities as the First Claim. Thus, by its terms, the Third Amended Consolidated Complaint based each of the claims on identical activities of the director defendants.

## C. Proceedings Below.

### 1. Intervention of the FDIC Prior to the Third Amended Consolidated Complaint.

After the class actions were consolidated in the Southern District of California, the FDIC moved to intervene and to displace the shareholder-plaintiffs. At about the same time the director defendants moved to dismiss the complaint.

In ruling on the FDIC's motion, the district court determined that the FDIC's intervention was proper. However, the district court dismissed the alleged violations of §10(b) of the Securities Exchange Act on the ground that the asserted fraud did not take place in connection with the purchase or sale of any security. Moreover, it denied the FDIC's motion to dismiss the shareholders' claims under the National Bank Act and pendent state law, holding that the FDIC could not preclude minority shareholders from proceeding as plaintiffs.

The district court certified its ruling on the FDIC's motion for appeal under 28 U.S.C. §1292(b), and stated:

> "The question of the shareholder-plaintiffs' right to maintain an individual and representative action in their own right under §93 of the National Banking Act and under state law for breach of fiduciary duty and fraud where the only damages claimed are the diminution of the value of their shares after the bank failed involves a controlling question of law upon which there is a substantial ground for difference of opinion, the decision of which will materially advance the ultimate determination of this litigation."

No appeal was taken from the dismissal of the §10(b) claims. The district court also entered an "Order Certifying Class Action." This order defined the plaintiff class as "all persons and entities, excluding the defendant shareholders, who were beneficial owners of United States National Bank common stock on October 18, 1973." The district court further reserved the right to limit the class at a future date.

In this posture the case went to the Ninth Circuit on the certified questions.

**2. Interlocutory Review by the Ninth Circuit Prior to the Third Amended Consolidated Complaint.**

On August 10, 1976, the Ninth Circuit ruled on the interlocutory appeal. *Harmsen v. Smith*, 542 F.2d 496 (9th Cir. 1976). Specifically it held: 1) "that the district court properly declined to dismiss in its entirety the complaint of minority shareholders with respect to its allegations of violations of the National Banking Act," and 2) "that minority shareholders may, under Section 93 of the National Banking Act, maintain in their own right a cause of action for damages after their bank has failed where the only damages claimed are the diminution of the value of their shares." (*Id.*, p. 499)

In reaching this decision the Court relied on the Supreme Court opinion in *Chesbrough v. Woodworth*, 244 U.S. 72,

76, 37 S.Ct. 579, 582 (1917), and noted that a plaintiff must demonstrate that the damages he seeks are personal to him. "Section 93 does not permit him to recover for injuries done to the bank of which the defendant is a director." (*Id.*, p. 500)

The *Harmsen I* opinion also cautioned the district court that its interlocutory ruling might make "it necessary for the district court to review its certification of this action as a class action." (*Id.*, p. 503)

The Ninth Circuit further held that "Section 93 does not purport to empower shareholders or other persons to initiate direct causes of action on their own behalf with respect to any violation of federal banking law by a director of a national bank. To the contrary, the scope of Section 93 is limited to violations of 'any of the provisions of this chapter,' which refers to Chapter 2 of Title 12 of the United States Code." (*Id.*, p. 501) The opinion of the Court continued as follows:

> "[W]e should point out that Chesbrough holds that the cause of action authorized by Section 93 'is exclusive and precludes a common-law liability for fraud and deceit.' 244 U.S. at 78, 37 S.Ct. at 582. Thus pendent state law claims asserted by the plaintiffs here must be with respect to causes not authorized by reason of Section 93. Violations of federal law resulting in injuries for which shareholders may bring a personal action under Section 93 must be determined and measured by federal law. The relief afforded for such violations is a federal remedy. State law may not afford a similar remedy." (*Id.*, p. 502)

At the end of its opinion the *Harmsen I* Court noted that the "count in the complaint based on these provisions [§10(b) of the Securities Exchange Act of 1934] has been dismissed and no appeal taken therefrom," and ended by stressing

that Section 93 provides the exclusive remedy:

> "We close by stating that we do not pass on the sufficiency of those counts of the complaint alleging causes of action under state law. That question was not properly before us on this appeal. We merely call attention once more to the fact that Section 93, to the extent of its scope, provides the exclusive remedy." (*Id.*, p. 503)

**3. The Third Amended Consolidated Complaint and Proceedings in the District Court Following the Decision in *Harmsen I*.**

Following the Ninth Circuit's opinion in *Harmsen I*, the district court permitted the plaintiffs to file their Third Amended Consolidated Complaint, which reintroduced the previously dismissed §10(b) claims despite the district court's earlier ruling that the alleged fraud had not taken place in connection with the purchase or sale of any security.

Thereafter, an attack was made on various portions of the new complaint, including the inclusion of the §10(b) claims and the other pendent claims. However, the district court held that the non-National Bank Act claims might not infringe upon the exclusivity of the National Bank Act remedy and reserved to the trial further rulings to limit or exclude the presentation of the pendent claims insofar as they would infringe on the exclusivity of the Bank Act remedy. However, the district court's reservations were soon forgotten. Under the Third Amended Consolidated Complaint each of the claims was based on the same alleged activities of the director defendants.[2] At trial, evidence as to these

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[2]Prior to trial, the district court entered an order approving a settlement agreement between the plaintiffs and 17 directors of the Bank who had originally been named defendants. The average of this settlement totalled slightly in excess of $39,500 per director. Non-directors Shannon and Toft were found liable for compensatory and punitive damages in the respective sums of $9,624,170 and $8,689,022.

facts was received without qualification and submitted to the jury as a single package upon which they were to make their decision with respect to all claims.

Moreover, the trial court had certified the class as "all persons and entities, excluding the defendant shareholders, who were beneficial owners of United States National Bank common stock on October 18, 1973" as the proper class under the National Bank Act at a time when no action under §10(b) was pending. At no time did the court attempt to define the class with reference to the subsequent claims under §10(b) of the Securities Exchange Act. Thus, the class as defined would contain USNB shareholders who acquired the stock before any of the alleged violations of §10(b) were alleged to have occurred.

Despite these errors by the district court, the Court of Appeals in its opinion following trial, which is the subject of this petition, affirmed the judgment against Shannon and Toft.

## REASONS FOR GRANTING THE WRIT.

### 1. The Court of Appeals' Opinion Has Departed From This Court's Prior Opinions as to the Exclusivity of the National Bank Act. Section 93 of the Act Provides the Exclusive Remedy Against Bank Directors and the Lower Court Was Without Jurisdiction to Enter Judgment Under the §10(b) and Pendent State Claims.

This case involves an unwarranted effort by attorneys representing four members of an alleged class of 4,000 shareholders to invoke the exclusive remedy embodied in Section 93 of the National Bank Act against the directors of a national bank on the basis of actions taken by such directors and, at the same time, to pursue remedies under the Securities Exchange Act and state law for the same activities by these same directors. The plaintiffs in this case availed themselves of the exclusive remedy afforded them against bank directors by Section 93 of the National Bank Act. As a result, they secured a judgment against C. Arnholt Smith and entered into a settlement with the other director defendants for sums of money, which were relatively small by comparison to the awards they later secured against the non-director defendants. (*See* footnote 2, *supra*.)

Having employed the exclusive remedy available against the bank directors, the lower court was without jurisdiction to entertain an action by the plaintiffs against any of the non-director defendants, such as Shannon and Toft, under the federal securities laws or pendent state claims based upon the same alleged activities.

As noted in the statement of the case, the record below is clear that the claims under the Securities Exchange Act and the pendent state claims were based upon the same alleged director defendant activity as the claim under the

National Bank Act. The record also is clear that the evidence received at trial as to the alleged misconduct by the directors was submitted in an effort to establish the various claims against Shannon and Toft. Indeed, in submitting to the jury the Section 93 claim, the §10(b) claim and the pendent state claims, the district court gave instructions which would permit the jurors to consider the same director actions and the same evidence with respect to each claim.

Since the 1907 decision by this Court in *Yates v. Jones National Bank*, 206 U.S. 158, 27 S.Ct. 638 (1907), it has been settled law that actions taken by bank directors and governed by the National Bank Act are exclusively governed by the specific provisions of that Act. *See also, Chesbrough v. Woodworth*, 244 U.S. 72, 37 S.Ct. 579 (1917). Moreover, in the *Harmsen I* opinion, the Court of Appeals followed this controlling principle and held that Section 93 of the Act provides the exclusive remedy. Yet, in its opinion following trial, the Court of Appeals held that the National Bank Act does not provide the exclusive remedy and upheld claims based upon §10(b) and pendent state causes of action.

Shannon and Toft respectfully submit that the lower court was without jurisdiction to entertain an action under §10(b) or the state causes of action, because Section 93 provided the exclusive remedy. The plaintiffs' effort, as upheld by the Court of Appeals, to use §10(b) for the purpose of supplanting the exclusive remedy in the National Bank Act is further undermined by the fact that the claim was asserted as an implied private cause of action for damages. In recent cases, this Court has declined to take an expansive reading of the federal securities statutory formulation, and has instead looked closely at the language of the federal securities laws and at the legislative history and intent. *See Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S.Ct. 242 (1979); *Touche Ross & Co. v. Redington*,

442 U.S. 560, 99 S.Ct. 2479 (1979); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 97 S.Ct. 1292 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975).[3]

Prior to its decision in the instant case, the Ninth Circuit had also taken a restrictive view as to implied causes of action. For example, in *Starbuck v. San Francisco*, 556 F.2d 450 (9th Cir. 1977), the court held that there was no implied private cause of action in the Raker Act. Also, in *Keaukaha-Panaewa Community Association v. Hawaiian Homes Commission*, 588 F.2d 1216 (9th Cir. 1978), the court held that the Federal Hawaii Admission Act did not create an implied cause of action permitting a private party to maintain a lawsuit.

Nothing in the language or legislative history of §10(b) indicates that Congress intended to make any changes in the National Bank Act which provides the exclusive civil remedy for damages resulting from violations of certain provisions in the Act. As this Court has noted, "Section 10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage." *Blue Chip Stamps v. Manor Drug Stores, supra*, 421 U.S. at 729, 95 S.Ct. at 1922.

On the other hand, the National Bank Act has been recognized as providing the exclusive civil damage remedy with respect to its provisions for more than a quarter of a

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[3]Indeed, this Court has recently observed that it has specifically reserved the issue of aider and abettor liability, such as that imposed by the lower court on Shannon and Toft, under §10(b). *Herman & MacLean v. Huddleston*, .... U.S. ...., 103 S.Ct. 683, 686 n.5 (1983).

century before §10(b) was passed. As late as 1968, this Court refused to alter the structure of the Bank Act or tamper with its operations. *See First Agricultural Bank v. State Tax Com'n*, 392 U.S. 339, 88 S.Ct. 2173 (1968).

Nothing in the legislative history indicates that Congress intended to alter the exclusive remedy provided in Section 93 of the National Bank Act when it passed §10(b) of the Securities Exchange Act. Without specific legislative direction, it is clear that there is no basis for imputing a congressional intention to compromise the exclusive remedy contained in the National Bank Act. As this Court has noted: "A private remedy should not be implied if it would frustrate the underlying purpose of a legislative scheme." *Cannon v. University of Chicago*, 441 U.S. 677, 703, 99 S.Ct. 1946, 1961 (1979). And as noted in *Blue Chip Stamps v. Manor Drug Stores, supra*, 421 U.S. at 736, 95 S.Ct. at 1925-1926: "It would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action."

The National Bank Act is part of the national legislative scheme. It governs an essential element in the national economy. Section 93 of the Act provides an exclusive civil remedy against bank directors and is part of the congressional program in the banking industry. Neither the legislative history nor the language of §10(b) suggests a congressional intent to change the exclusive remedy under Section 93. As a result, it is submitted that the lower court was without jurisdiction to entertain the §10(b) claims or the pendent state causes of action. This is especially true with respect to the §10(b) and pendent state claims against Shannon and Toft. Again, these claims were based on the same director activity as the claim under the exclusive remedy in the National Bank Act. As a result, the district court had

no jurisdiction to entertain §10(b) or the pendent state claims against the directors; and under these circumstances, there could be no secondary liability against Shannon or Toft since there could be no primary liability by the directors under those claims.

In its opinion following trial, the Court of Appeals attempted to reconcile the exclusivity of the National Bank Act vis-a-vis the federal securities laws by citing this Court's opinion in *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 96 S.Ct. 1989 (1976). However, in that case, the class action against the national banking association solely concerned allegations that the bank had violated the federal securities laws by failing to disclose its knowledge of certain adverse financial information about one of its customers and violations of the securities laws by that customer. Although this Court was solely concerned with the venue provisions of the National Bank Act and the federal securities laws, it is clear that the type of alleged improper conduct in *Radzanower* did not fall within the purview of the National Bank Act. Again, in the instant case, each of the claims was based upon the alleged director misconduct under the National Bank Act. By utilizing this exclusive remedy, the plaintiffs could not properly proceed with §10(b) and pendent state claims.

**2. The Plaintiff Class Was Not Properly Certified and the Plaintiffs Had No Standing to Bring a Class Action Under §10(b) and the Pendent State Causes of Action.**

Plaintiffs in this case were improperly certified as a class and failed to meet the standing requirement established in *Blue Chip Stamps v. Manor Drug Stores, supra.* In that case this Court unequivocally adopted the rule enunciated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2nd

Cir. 1952) and held that the *Birnbaum* rule should determine whether there was standing to sue under §10(b).

Under the *Birnbaum* rule as adopted in *Blue Chip Stamps v. Manor Drug Stores, supra*, the statutory language "purchase or sale of any security" is to be afforded strict construction and potential purchasers or potential sellers do not have standing to bring suit under §10(b). Specifically, the Court held that among the classes of plaintiffs barred by the *Birnbaum* rule were "actual shareholders . . . who allege that they decided not to sell their shares because of an unduly rosey representation or a failure to disclose unfavorable material." (*Id.* 421 U.S. at 737-738, 95 S.Ct. at 1926). Thus, under the rule, a potential seller of stock does not have standing to sue on the theory that he "failed to purchase or sell stock by reason of a defendant's violation of Rule 10b-5." (*Id.* 421 U.S. at 745, 95 S.Ct. at 1930)

Moreover, the Court's rationale is supportive of its declared purpose to prevent strike suits and vexatious litigation:

> "[I]n the absence of the Birnbaum rule, it would be sufficient for a plaintiff to prove that he had failed to purchase or sell stock by reason of a defendant's violation of Rule 10b-5. . . . Plaintiff's proof would not be that he purchased or sold stock, a fact which would be capable of documentary verification in most situations, but instead that he decided not to purchase or sell stock. . . . The very real risk in permitting those in respondent's position to sue under Rule 10b-5 is that the door will be open to recovery of substantial damages on the part of one who offers only his own testimony to prove that he ever consulted a prospectus of the issuer, that he paid any attention to it, or that the representations contained in it damaged him." 421 U.S. at 745-46, 95 S.Ct. at 1930.

In certifying the class in this action the district court and plaintiffs' attorneys acted in apparent disregard of this clear

mandate. Specifically, on June 27, 1975, at a time when there was no pending action under §10(b) the court entered its order describing the class as follows:

> "All persons and entities, excluding the defendant shareholders, who were beneficial owners of United States National Bank common stock on October 18, 1973."

Over repeated objections by the defendants the court later used this same class under §10(b).

Thus, no regard was shown for the key language in §10(b) that the manipulative or deceptive device or contrivance must be "in connection with the purchase or sale" of a security.

Moreover, USNB had been in operation since at least 1933 and the members of the asserted class might have purchased their stock at any time in a 40-year period. As a result, many members of the class were clearly in the category of "actual shareholders" and any alleged loss which they experienced would have resulted because "they decided not to sell their shares because of an unduly rosey representation or a failure to disclose unfavorable material." In this respect the testimony of Harmsen and Rosenberg, the two named plaintiffs who testified at trial, is revealing. Harmsen purchased his stock in 1963 and Shannon was found to have become secondarily liable under §10(b) on March 1, 1971, some eight years after Harmsen purchased the stock; Toft was found to have become secondarily liable under §10(b) on March 1, 1968, some five years after Harmsen purchased the stock. Similarly, Rosenberg acquired his USNB stock in 1967,[4] some four years prior to the time

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[4]Rosenberg repeatedly testified that he acquired his USNB stock in 1967, although on one occasion he stated that he "possibly" acquired it in 1968. The record is clear, however, that at the latest Rosenberg acquired his stock in February 1968. Moreover, in acquiring his stock, Rosenberg testified that he relied solely on a letter from Smith and USNB's 1966 Annual Report.

Shannon became secondarily liable and before Toft became secondarily liable.

Moreover, the district judge because of the ruling with respect to §93 of the National Bank Act in *Harmsen v. Smith, supra*, 542 F.2d at 496, that plaintiffs may maintain "a cause of action for damages after their bank has failed where the only damages claimed are the diminution of the value of their shares" instructed the jurors that in assessing damages under §10(b) they could consider "the market value of the United States National Bank after full and public disclosure of all the defendants' improper activity was made." Clearly, the theory of damages was that regardless of when the stock was purchased, the plaintiffs were damaged as prospective sellers by the alleged failure of defendants to reveal subsequent improper activity.

Thus, although plaintiffs argued that they were suing as purchasers of stock, the facts of the litigation and instructions of the court establish that they sued as potential sellers to recover for the diminution of the value of their stock.

Furthermore, the fact that the plaintiffs alleged a conspiracy theory could not give rise to any liability on the part of Shannon and Toft. The conspiracy theory espoused by the plaintiffs and adopted by the district court completely fails legal examination. "Conspiracy" to violate §10(b) is not a legally cognizable violation. Rather, the "*gravamen of an action in civil conspiracy is not the conspiracy itself but the underlying wrong which would be actionable absent the conspiracy.*" *McLaughlin v. Copeland*, 455 F.Supp. 748, 752 (D.Del.), *affirmed*, 595 F.2d 1213 (3rd Cir. 1978) (emphasis added.) Inasmuch as Shannon and Toft's alleged liability was found by the jury to have started after the class representatives had purchased their stock, and in view of the fact that the district court certified a class of shareholders rather than purchasers or sellers, it is axiomatic (1) that the

class representatives could not allege a cause of action against petitioners and (2) that the district court improperly certified the class as one of shareholders or those who retained their shares, *i.e.*, those who were not purchasers or sellers vis-a-vis Shannon and Toft. Clearly, the *Birnbaum* doctrine has been disregarded for the purposes of this case, and liability under §10(b) has been impermissibly expanded contrary to this Court's opinion in the *Blue Chip Stamps* case.[5]

Because the plaintiffs could not validly allege a §10(b) claim against Shannon and Toft, it is equally clear that the

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[5]Other courts have refused to ignore the "in connection with" language of §10(b) as interpreted in *Birnbaum* and as adopted in *Blue Chip Stamps*. These courts have held that there is no §10(b) cause of action regardless of whether the plaintiffs allege "conspiracy" or some other type of "continuing fraud." For example, in *Ingenito v. Bermec Corporation*, 376 F.Supp. 1154 (S.D.N.Y. 1974), the plaintiffs brought several actions for violation of the federal securities laws against not only the investment entity but also against so-called noteholder defendants who had acquired the plaintiffs' promissory notes after the plaintiffs had purchased their securities. Thus, the allegations in the *Ingenito* case were similar to those made against Shannon and Toft. In *Ingenito*, the plaintiffs alleged that the noteholder defendants were aware of fraud in the investment entity's sales practices and claimed that these defendants conspired with the other defendants to conceal the precarious financial condition of the investment entity. The *Ingenito* Court noted that the plaintiffs' claims against the noteholder defendants "cast them as co-conspirators or aiders and abettors of the alleged fraud" by the other defendants. However, since the plaintiffs' claims were based upon purported post-transaction fraud and not fraud in connection with the purchase or sale of any security, the *Ingenito* Court dismissed the claims. In a subsequent opinion dealing with the matter, *Ingenito v. Bermec Corporation*, 441 F.Supp. 525, 545 (S.D.N.Y. 1977) the court stated:

> "Restating the *Birnbaum-Blue Chip* rule: when fraud results merely in the retention of securities no relief may be had under 10b-5. The proscription applies regardless of the nature of the retention-inducing fraud."

For other decisions holding that fraudulent activity following the purchase or sale of securities cannot give rise to a §10b claim, see *Williams v. Sinclair*, 529 F.2d 1383 (9th Cir.), *cert. denied*, 426 U.S. 939, 96 S.Ct. 2651 (1976); *Marsh v. Armada Corp.*, 553 F.2d 978 (6th Cir. 1976); *Mendelsohn v. Capital Underwriters, Inc.*, 490 F.Supp. 1069 (N.D. Cal. 1979); *Morgan v. Prudential Funds, Inc.*, 446 F.Supp. 628 (S.D.N.Y. 1978); *Halperin v. Edwards and Hanly*, 430 F.Supp. 121 (E.D.N.Y. 1977).

judgment under the pendent state causes of actions must also fail. It is the *sine qua non* of pendent state claims that independent federal jurisdiction exist. See, *e.g.*, *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979). Moreover, the fact that the district court permitted the litigation not only of §10(b) claims but also the pendent state causes of action cannot support the judgment. In *Libby, McNeill, and Libby v. City National Bank*, 592 F.2d 504, 510 (9th Cir. 1978) judgments after trial on behalf of certain claimants were vacated because of the lack of federal jurisdiction. Although these judgments incorporated pendent state theories, the court noted the "strong circuit policy against pendent party jurisdiction," and held that jurisdiction could not be saved because pendent jurisdiction "does not reach parties for whom there is no independent basis for federal jurisdiction . . ." See also *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3rd Cir. 1976).

**3. The Court of Appeals Has Impermissibly Expanded Secondary Liability Under §10(b). Petitioners, Who Were Never Officers or Directors of the Bank, Lacked Any Duty to Inform the Bank's Shareholders of the Bank's Financial Condition. Further, Petitioners Lacked the *Scienter* Necessary to Establish a Violation Under §10(b) or the Pendent State Causes of Action.**

As noted, neither Shannon nor Toft was an officer, director, or employee of USNB. Neither participated in the issuance of statements to shareholders on behalf of the Bank. Neither was involved with any plaintiff in purchasing or selling USNB stock. Under these circumstances, "the element required to make silence fraudulent — a duty to disclose — is absent in this case." *Chiarella v. United States*, 445 U.S. 222, 232, 100 S.Ct. 1108, 1116 (1980). In the

*Chiarella* case, this Court made the following statement, which is appropriate to the position of Shannon and Toft in this litigation:

> "No duty could arise from petitioner's relationship with the sellers of the target company securities for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was in fact a complete stranger who dealt with the sellers only through impersonal market transactions." (*Chiarella v. United States, supra*, at 445 U.S. 232-33, 100 S.Ct. 1116-1117)

The considerations noted in *Chiarella* apply forcefully to Shannon and Toft. At most, the evidence at trial established that Shannon and Toft were customers, or employees of customers, of United States National Bank and that as customers they secured loans from the bank. However, these facts were and are insufficient to make Shannon and Toft corporate insiders or fiduciaries. Furthermore, nothing in the record supports a conclusion that either Shannon or Toft ever used undisclosed information to benefit personally in the purchase or sale of stock. As noted in *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1981):

> "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction."

Furthermore, the record in this case fails to disclose that either Shannon or Toft had the requisite *scienter* required to violate §10b. See, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375 (1976). Inasmuch as neither Shannon nor Toft ever used any undisclosed information for their benefit in the purchase or sale of the bank stock, it would, in the words of this Court in the *Hochfelder* decision, "add a gloss to the operative language of the statute quite different

from its commonly accepted meaning,'' to uphold §10b liability against Shannon and Toft. Furthermore, the evidence is clear that Shannon and Toft intended that their corporations would repay the loans from United States National Bank. Shannon's corporation had extensive land holdings to guarantee the loans and the Westgate loans developed through Toft were repaid and Westgate had substantial assets at the time the loans were made. Nothing in the record supports the finding that Shannon and Toft had the requisite *scienter* as required under §10b.

Also, the evidence at trial failed to uphold the finding that Shannon and Toft violated any duty under the pendent state claims. In this regard, the plaintiffs' injection of a conspiracy theory with respect to the pendent state claims could not, as a matter of law, uphold a judgment against petitioners. Indeed, under the district court's instructions, the jury could have found Shannon and Toft liable for the illegal acts and statements of other defendants pursuant to one or more of the alleged conspiracies not relating to Shannon and Toft. This fatal defect at the trial was of the very type condemned by this Court in *Kotteakos v. United States*, 328 U.S. 750, 56 S.Ct. 1239 (1946).

Lastly, the jury's findings as to the commencement dates of the liability of Shannon and Toft clearly precluded any award of damages against these defendants under any of the plaintiffs' theories, including the pendent state claims. As a matter of proximate causation, the plaintiffs simply were not damaged by the conduct of Shannon and Toft. As noted, the jury found that Shannon's and Toft's liability commenced in March, 1971, and March, 1968, respectively. The plaintiffs' evidence of causation and damages purported to establish that by 1968 USNB stock was worthless. Thus, Shannon and Toft could not have caused any loss to the plaintiffs. Under both federal and applicable California law,

it is well settled that, as to any theory of liability, compensatory damages must be proven to be the proximate result of the defendants' conduct. See, *e.g.*, *Fey v. Walston & Co., Inc.*, 493 F.2d 1036 (7th Cir. 1974); *Classic Bowl, Inc. v. AMF Pinspotters, Inc.*, 403 F.2d 463 (7th Cir. 1968); *O'Neill v. Spillane*, 45 Cal.App.3d 147, 119 Cal.Rptr. 254 (1975).

Also, under California law, which is applicable in the jury's awards of punitive damages, such damages must fall when a plaintiff's claim for compensatory damages falls. *Vice v. Automobile Club of Southern California*, 241 Cal.App.2d 759, 50 Cal.Rptr. 837 (1966).

**CONCLUSION.**

This is a classic case in which a far-flung class action has led the lower courts into a series of errors which cannot be reconciled with the National Bank Act, §10(b) of the Securities Exchange Act, Rule 23 of the Federal Rules of Civil Procedure, and traditional damage and conspiracy theories. If permitted to stand, the judgment below, as affirmed by the Court of Appeals, would not only impose an insider's fiduciary duty on petitioners, who were not in any position of authority in USNB, it would also controvert public policy and recognized principles of jurisdiction, as well as encourage strike suits and vexatious litigation, and thwart the legislative design.

For the reasons stated above, a Writ of Certiorari should issue to review the opinion of the Court of Appeals for the Ninth Circuit.

Dated: June 1, 1983.

Respectfully submitted,

THOMAS R. SHERIDAN,

*Attorney for Petitioners,*
*Carol Smith Shannon and*
*Philip A. Toft.*

*Of Counsel:*

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## APPENDIX A.

Appeal from the United States District Court for the Southern District of California.

Before SKOPIL and SCHROEDER, Circuit Judges, and AGUILAR,* District Judge.

SCHROEDER, Circuit Judge.

This case arose out of the failure of United States National Bank (USNB) of San Diego and the disintegration of the financial empire of its former officer, director, and controlling shareholder, C. Arnholt Smith (C. Arnholt). C. Arnholt, in connection with members of his family and the directors and officers of corporations be controlled, allegedly engaged in continuing fraudulent activities from 1962 until 1973. Specifically, C. Arnholt, with his daughter Carol Smith Shannon (Shannon), his brother John, his wife Helen, numerous directors of USNB, and others allegedly materially misled USNB shareholders about the many illegal transactions in which defendants were engaged. These transactions generally took three forms: (1) misrepresentation of loan purposes on the books of USNB; (2) granting of loans in excess of National Bank Act (Bank Act) requirements and for insufficient collateral; and (3) funneling USNB loans for undisclosed personal gain.

On October 18, 1973, the Comptroller of the Currency declared USNB insolvent and appointed the Federal Deposit Insurance Corporation receiver. Subsequently, two class actions on behalf of minority shareholders were filed against C. Arnholt and the other USNB directors; Shannon, Helen, John, and the corporation John controlled, First National Finance Corporation (FNFC), were also named as defen-

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*Honorable Robert P. Aguilar, United States District Judge, Northern District of California, sitting by designation.

dants, along with Phillip A. Toft (Toft), an officer and director of Westgate-California Corporation, a major conglomerate that included many Smith-controlled businesses. The two suits were consolidated into the present action.

In June 1974, the FDIC moved to intervene and be substituted for the minority shareholders. The district court permitted intervention but ruled that, under the Bank Act, the minority shareholders had a cause of action in their own right against the bank directors. We affirmed on interlocutory appeal, holding that minority shareholders have a cause of action under the Bank Act even when theh only damage claimed is the diminution of the value of their shares. *Harmsen v. Smith*, 542 F.2d 496, 499 (9th Cir. 1976) (*Harmsen I*).

In May 1979, all directors of USNB, with the exception of C. Arnholt, settled, and were dismissed from the case. A jury trial followed to determine the liability of C. Arnholt, Helen, Shannon, Toft, John, and FNFC. The trial was bifurcated as to questions of liability and damages.

Plaintiffs proceeded in the liability phase of the trial on three general theories. The first theory, an alleged violation of section 93 of the National Bank Act,[1] was tried against C. Arnholt alone. Second, all defendants were alleged to

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[1]12 U.S.C. § 93 provides in pertinent part:

(a) If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

have violated section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b),[2] and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5 (1981).[3] Primary violations were alleged against C. Arnholt; all other defendants were charged with secondary participation in the violations. The secondary section 10(b) theories alleged were "control person" liability under section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), aiding and abetting liability, and liability for conspiracy to violate section 10(b). Third, pendent state claims of fraud, conspiracy to defraud, abuse of control, and conspiracy to abuse control were tried against all parties.

The jury returned a verdict against C. Arnholt on the Bank Act claim, the section 10(b) primary claim, the section 10(b) conspiracy claim, and the four pendent state claims. Helen, Shannon, Toft, John, and FNFC were found liable for secondary violations of section 10(b) and for pendent state violations of fraud, conspirary to defraud, and con-

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[2]Section 10(b) provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[3]SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

spiracy to abuse control. No defendant except C. Arnholt was found liable for direct abuse of control.[4]

After the jury returned its verdicts in the liability phase of the trial, the district court, pursuant to plaintiffs' request, appointed a special master to gather data to be presented to the jury regarding plaintiffs' damages. The special master sent questionnaires to all USNB shareholders requesting various information, including the date they purchased their shares. The special master prepared two schedules, one based on the actual responses and one based on extrapolations from the actual responses. These schedules were presented to the jury to be considered in its calculation of damages. After instructions by the court, the jury awarded damages of several million dollars on each violation against each defendant.[5] Punitive damages were also awarded against

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[4]The nine counts were:

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| Count I | Violation of NBA § 93 |
| Count II | § 10(b) primary |
| Count III | § 10(b) controlling person |
| Count IV | § 10(b) aiding and abetting |
| Count V | § 10(b) conspiracy |
| Count VI | Fraud |
| Count VII | Conspiracy to defraud |
| Count VIII | Abuse of control |
| Count IX | Conspiracy to abuse control |

The jury found the defendants liable on the following counts:

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| C. Arnholt | Counts I, II, V, VI, VII, VIII, IX |
| Helen | Counts III, IV, V, VI, VIII, IX |
| Shannon | Counts III, IV, V, VI, VII, IX |
| Toft | Counts IV, V, VI, VII, IX |
| John | Counts IV, VI, VII, IX |
| FNFC | Counts IV, VI, VII, IX |

[5]The jury awarded damages against each defendant in the following amounts:

each defendant with respect to the state law violations. Upon

| | |
|---|---|
| C. ARNHOLT SMITH | |
| Count I | $12,298,708.11 |
| Count II | $12,061,417.72 |
| Count V | $ 8,689,021.25 |
| Count VI | $12,061,417.72 |
| Count VII | $11,614,538.21 |
| Count VIII | $11,085,494.77 |
| Count IX | $10,722,476.63 |
| Punitive Damages (Counts VI, VII, VIII, and IX only) | $11,000,000.00 |
| HELEN SMITH | |
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII and IX only) | $ 750,000.00 |
| CAROL SMITH SHANNON | |
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII, and IX only) | $ 3,000,000.00 |
| PHILIP A. TOFT | |
| Count IV | $ 8,689,021.25 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 8,689,021.25 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII, and IX only) | $ 1.00 |
| JOHN A. SMITH | |
| Count IV | $11,614,538.21 |
| Count VI | $11,614,538.21 |
| Count VII | $11,614,538.21 |
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII, and IX only) | $ 1.00 |
| FIRST NATIONAL FINANCE CORPORATION | |
| Count IV | $ 2,861,957.38 |
| Count VI | $ 2,861,957.38 |
| Count VII | $ 2,861,957.38 |
| Count IX | $ 2,868,933.92 |
| Punitive Damages (Counts VI, VII, and IX only) | $ 1.00 |

motion of the defendants, the court reduced compensatory damages to the maximum amount for which each defendant was found liable under any one count, and retained punitive damages in full.[6]

Each defendant now appeals and raises a number of number of issues. Aside from questions concerning the general sufficiency of the evidence, the principal contentions of the separate defendants can be summarized as follows:

Helen, joined by the other defendants, focuses her arguments on the propriety of the jury verdict against her under the Securities Exchange Act. As a preliminary matter, she asks this court to reexamine prior holdings that there exists a private right of action under section 10(b).

C. Arnholt does not appeal the adverse verdict of over $12,000,000 for violation of the Bank Act. He does contend, however, that any liability based on section 10(b) or on the pendent state claims was improper because section 93 of the Bank Act provides the exclusive remedy against a bank director.

All of the defendants, other than C. Arnholt, urge that they could not have been secondarily liable under section 10(b) if no primary violation of the same statute was properly asserted against C. Arnholt. They further argue that if no federal cause of action existed against them under section 10(b), the court was without jurisdiction to consider the pendent state law claims. A key jurisdictional issue is, therefore, the claimed exclusivity of the Bank Act.

John and FNFC's principal argument is that the jury was wrongfully instructed to give conclusive effect to the spe-

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[6]With respect to C. Arnholt, for example, damages as shown in footnote 5, *supra*, were reduced to $12,298,708.11 compensatory plus $11,000,000.00 punitive. Damages awarded against the other defendants were reduced similarly.

cific findings made in a related bankruptcy case, *In re Westgate-California Corp.*, No. 74-413 (S.D.Cal. Feb. 9, 1978). The court there found that John and FNFC had been involved in fraudulent transactions with USNB. The court recently reversed that decision. *Westgate-California Corp. v. First National Finance Corp.*, 650 F.2d 1040 (9th Cir. 1981).

Defendants also assert that the pendent state claims are wholly derivative and cannot be maintained by the shareholders themselves. Finally, all defendants also claim irregularities with respect to class certification and the damages calculation.

I

*Preliminary Issues*

[1] We begin with the assertion by Helen that this case presents an appropriate opportunity to "reexamine" the availability of a private right of action under section 10(b) of the Securities Exchange Act. We find no such need. The Supreme Court has clearly established the right of individual enforcement under section 10(b) and Rule 10b-5. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196, 96 S.Ct. 1375, 1382, 47 L.Ed.2d 668 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729-30, 95 S.Ct. 1917, 1922-23, 44 L.Ed.2d 539 (1975); *Affiliated Ute Citizens v. United States* 406 U.S. 128, 150-54, 92 S.Ct. 1456, 1470-72, 31 L.Ed.2d 741 (1972); *Superintendent of Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6, 13 n. 9, 92 S.Ct. 165, 169, 30 L.Ed.2d 128 (1971). Helen's suggestion that the recent Supreme Court decisions in *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), and *Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979), cast some doubt on the continued validity of the

private right of action under section 10(b) is not persuasive. Those cases considered private rights of action under different statutory provisions with different legislative histories. They do not indicate that section 10(b) falls short of meeting the test for implying private rights of action set forth in *Cort v. Ash*, 422 U.S. 66, 78, 95 S.Ct. 2080, 2088, 45 L.Ed.2d 26 (1975).

The next issue is the claimed exclusivity of section 93 of the Bank Act. We address whether pendent state law claims or section 10(b) claims can be maintained against C. Arnholt for conduct that also allegedly violates section 93.

The question of the availability of relief under state law for conduct covered by the Bank Act has not been litigated often. This court has, however, in the earlier interlocutory appeal of this case, *Harmsen I, supra*, considered the issue. In *Harmsen I* we stated that

> [P]endent state law claims asserted by the plaintiffs here must be with respect to causes not authorized by reason of Section 93. Violations of federal law resulting injuries for which shareholders may bring a personal action under Section 93 must be determined and measured by federal law. The relief afforded for such violations is a federal remedy. State law may not afford a similar remedy.

542 F.2d at 502. The *Harmsen* court relied on a much earlier statement by the Supreme Court in *Chesbrough v. Woodworth*, 244 U.S. 72, 78, 37 S.Ct. 579, 582, 61 L.Ed. 1000 (1917), that section 93 "is exclusive and precludes a common-law liability for fraud and deceit." This conclusion in *Chesbrough*, in turn, was based on the Court's earlier opinion in *Yates v. Jones National Bank*, 206 U.S. 158, 27 S.Ct. 638, 51 L.Ed. 1002 (1907). The *Yates* Court concluded that the Bank Act cause of action must be exclusive as against pendent state claims in order to shield bank

directors from standards of liability that varied from state to state. *Id.* at 178, 27 S.Ct. at 645.

[2] We thus follow our earlier conclusion in *Harmsen I* that, for purposes of uniformity, state law causes of action are not allowable if the allegedly wrongful conduct comes within the scope of the National Bank Act. Liability against C. Arnholt under the pendent claims cannot be supported to the extent that the section 93 cause of action was based on the same conduct. If, on the other hand, the pendent claims against C. Arnholt were based on conduct outside the reach of the Bank Act, considerations of uniformity would not apply; and section 93 would not bar such claims.

[3] The provisions of the Bank Act proscribe specific conduct and are limited in coverage. *See, e.g.*, 12 U.S.C. §§ 82, 84. *See also Harmsen I*, 542 F.2d at 501 (section 93 relief limited to actions proscribed within Chapter 2 of the Bank Act). The complaint alleges, and the record clearly shows that C. Arnholt was engaged in fraudulent activity that went far beyond the narrow range of conduct prohibited by the Act. The district court judge specifically so held in his denial of defendants' motion for judgment n.o.v., and we agree. We thus conclude that the district court acted properly in considering the pendent claims against C. Arnholt.

[4, 5] An additional defense argument is that, even if section 93 is not the exclusive remedy against C. Arnholt, the district court did not properly distinguish between the two types of conduct and erroneously permitted the jury to consider evidence of C. Arnholt's section 93 violations when it considered liability under the pendent claims. However, defendants never formulated instructions to meet this present objection, and we hold that it is waived. *United States v. Burlington Northern, Inc.*, 500 F.2d 637, 639-40 (9th Cir. 1974). See 9 C. Wright & A. Miller, *Federal Practice and*

*Procedure* § 2552 (1971). Although a formal objection to proposed instructions may not be required when an appellant has previously made his position sufficiently clear to the trial court, *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766, 769 (9th Cir. 1982); *Brown v. Avemco Investment Corp.*, 603 F.2d 1367, 1370-75 (9th Cir. 1979), the record in this case does not reveal that defendants ever advised the district court of their view that the instruction did not correctly state the law.

[6] A separate question is whether section 93 of the National Bank Act restricts our ability to consider the section 10(b) claims. *Harmsen I* and the Supreme Court authority on which that case relied do not require dismissal; allowing a section 10(b) cause of action would not subject bank directors to varying standards of liability from state to state. Moreover, the language of the relevant statutes does not suggest that the Bank Act provision is exclusive. Section 10(b) of the 1934 Act and Rule 10b-5 make it unlawful for "any person" to engage in the conduct therein described. Congress did not exclude banks from the coverage of section 10(b), although it did specifically exempt banks from several other provisions of the securities laws. *See, e.g.*, 15 U.S.C. §§ 77c(a)(2), 77*l*(2); *cf.* 15 U.S.C. § 78c(a)(6). As stated by the Fifth Circuit in *Lehigh Valley Trust Co. v. Central National Bank*, 409 F.2d 989, 993 (5th Cir. 1969), "[t]hat Congress made no express general exemption for banks under the fraud provisions of either the Securities Act of 1933 or the Securities Exchange Act of 1934 indicates that Congress did not intend any such exemption." *Accord Carroll v. First National Bank of Lincolnwood*, 413 F.2d 353 (7th Cir.), *cert. denied*, 396 U.S. 1003, 90 S.Ct. 552, 24 L.Ed.2d 494 (1969) (banks subject to provisions of section 10(b)). For its part, the Bank Act provision does not contain any language limiting the application of other federal laws

to conduct within its reach.

Defendants fail to articulate any reasons for not applying section 10(b) in this context. The application of section 10(b) to bank directors burdens them with no duties or responsibilities that conflict with the directives of the Bank Act. It does impose additional duties or responsibilities, but we must construe the two potentially overlapping statutes in the manner that gives effect to each. We rely on the well recognized principle that "when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective." *Morton v. Mancari*, 417 U.S. 535, 551, 94 S.Ct. 2474, 2483, 41 L.Ed.2d 290 (1974). We therefore find no basis for holding that C. Arnholt, as a bank director subject to liability under the Bank Act, was exempted from liability under the Securities Exchange Act.

The single Supreme Court decision that discusses any relationship between the National Bank Act and the Securities Exchange Act is fully consistent with our conclusion. In *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 96 S.Ct. 1989, 48 L.Ed.2d 540 (1976), the Court held that the venue provision of the Bank Act, 12 U.S.C. § 94, governed venue in a suit against a national banking association for violation of the Securities Exchange Act. Although the focus of the Court in *Radzanower* was on the language and history of the venue provisions, the issue of venue would not have been considered at all had the Court felt that the Securities Exchange Act cause of action was improper because a national bank could be sued only under the Bank Act. We thus hold that there was no error in allowing causes of action under both section 10(b) of the Securities Exchange Act and section 93 of the Bank Act.

Because we hold that section 93 of the Bank Act is not an exclusive federal remedy, and that there was no error in

allowing plaintiffs to proceed against C. Arnholt for primary violations of section 10(b) or for alleged violations of state law (pendent claims), the remaining preliminary challenges are necessarily decided. It is unnecessary to consider the other defendants' argument that no secondary section 10(b) violations can properly be asserted unless a primary 10(b) violation is properly asserted. It is also clear that, because both the primary and secondary 10(b) claims were proper, there was an independent federal jurisdictional basis for the court to consider the pendent state claims against the other defendants. *United Mine Workers v. Gibbs*, 383 U.S. 715, 725, 86 S.Ct. 1130, 1138, 16 L.Ed.2d 218 (1966).

## II

## *Pendent Claims*

### A. *Plaintiffs' Standing Under State Law to Assert Pendent Claims*

[7] The defendants argue that the pendent claims asserted by the plaintiffs are, under California law, derivative claims which could not have been brought on the plaintiffs' own behalf but only on behalf of the bank.[7] The leading California case on a stockholder's right to sue in an individual capacity is *Jones v. H.F. Ahmanson & Co.*, 1 Cal.3d 93, 460 P.2d 464, 81 Cal.Rptr. 592 (1969). Chief Justice Traynor's opinion in that case recognized the general rule that there is no individual right of action for conduct of majority shareholders and directors which decreases the value of the corporation's stock. It went on to hold, however, that minority shareholders could assert a cause of action for

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[7]It is clear that a derivative claim could only have been brought against USNB by the FDIC. *Harmsen I*, 542 F.2d at 500-01 n. 2. *See Landy v. Federal Deposit Insurance Corporation*, 486 F.2d 139, 146-48 (3d Cir. 1973), *cert. denied*, 416 U.S. 960, 94 S.Ct. 1979, 40 L.Ed.2d 312 (1974).

injury to themselves, as opposed to injury to the corporation or injury incidental to the corporation's. *Id.* at 107, 460 P.2d at 471, 81 Cal.Rptr. at 599. The decision stressed the duty of majority shareholders to refrain from using their power to benefit themselves at the expense of the minority shareholders. *Id.*[8]

In this case the district court considered this standing question in light of applicable California authority; it concluded that the duty allegedly violated here was a duty to the shareholders separate from the duty to the bank and that the claimed injury was to the shareholders as individuals. In addition, the court carefully instructed the jury that it should consider only individual injury to the shareholders, i.e., injury separate from any injury to the bank and not incidental to the bank's injury.

We conclude that the district court did not err in its application of California law to the question of the standing of the shareholders to bring the pendent claims. The shareholders were allegedly damages in that they were induced to buy and hold stock which was worthless and which they would have known was worthless had they been aware of the defendants' misdeeds. The shareholders' injury is thus greater than the mere diminution of the value of their stock, for which only the corporation or a shareholder acting derivatively may normally seek recovery. The injuries here

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[8]California courts have consistently applied the Ahmanson analysis to suits brought by individual shareholders. *See, e.g., Smith v. Tele-Communications, Inc.*; 134 Cal.App.3d 338; 184 Cal.Rptr. 571 (1982) (minority shareholder action based on fraud upheld as individual suit); *Crain v. Electronic Memories and Magnetics*, 50 Cal.App.3d 509, 123 Cal.Rptr. 419 (1975) (same). *Cf. Truestone, Inc. v. Travelers Insurance Company*, 55 Cal.App.3d 165, 168, 127 Cal.Rptr. 386 (1976) (suit for diminution of value of shares allowed because not incidental to injury to corporation — third party tortfeasor had independent duty to individual shareholders.)

are properly characterized as "separate individual damages." *Sherman v. British Leyland Motors, Ltd.*, 601 F.2d 429, 440 n. 13 (9th Cir. 1979).

B. *Sufficiency of the Evidence — Pendent Claims*

[8] Defendants argue that there was insufficient evidence to support the jury's verdict on fraud, conspiracy to defraud, and conspiracy to abuse control. The principal contention is that plaintiffs failed to show that the defendants' involvement in concealed transactions had any material bearing on the purchase of shares. The record does contain expert opinion on the materiality of the concealed transactions. This opinion testimony was based on the undisclosed nature of the transfers between family-controlled entities, as well as on the size of the transactions. The record contains ample evidence of a conspiracy to misuse C. Arnholt's controlling position. Helen cannot logically maintain that because the jury refused to find that she herself abused control, it could not find that she conspired with C. Arnholt in connection with his abuse. The jury verdicts were supported.

III

*Class Certification and Related Issues*

A. *Class certification*

[9] Early in this litigation, before plaintiffs asserted any section 10(b) cause of action, the district court, pursuant to Fed.R.Civ.P. 23(b)(3), certified a class consisting of USNB shareholders as of October 18, 1973, the date the receiver was appointed. The section 10(b) claims were added to the class complaint after this court's decision in *Harmsen I, supra*.

The defendants correctly argue that only purchasers or sellers of stock have standing to bring a section 10(b) action,

*Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754-55, 95 S.Ct. 1917, 1934-35, 44 L.Ed.2d 539 (1975), and that the class certification should have been modified to include purchasers rather than shareholders. However, the erroneous denomination of the certified class was of no practical consequence; the instructions of the district court in the liability phase of the trial expressly required that the jury find against defendants on the section 10(b) and Rule 10b-5 claims only if plaintiffs established that defendants' conduct was "in connection with the purchase or sale of securities." In addition, in the damages pahse of the trial, the jury was specifically instructed to find damages based on purchases of stock. Given the district court's specific and unambiguous instructions to the jury that only pruchasers of stock could recover, appellants did not suffer any prejudice because the trial court failed formally to certify a subclass of purchasers.

[10] Defendants also complain that the district court erroneously failed to comply with Rule 23(c)(3) because the judgment did not describe the members of the class to whom they were liable. The present deficiency in the judgment has not prejudiced defendants and can easily and appropriately be corrected. On remand from this court, the district court shall enter judgment in accordance with Rule 23. *See Newman v. Prior*, 518 F.2d 97, 101 (4th Cir. 1975); *Young v. Katz*, 447 F.2d 431, 435 (5th Cir. 1971).

B. *10(b) Standing of class representatives*

[11] Helen, Shannon, and Toft all contend that plaintiffs lack standing to pursue section 10(b) claims against them because the two named plaintiffs who testified at trial both purchased their shares before 1968; the jury found that this was the earliest year in which these defendants were actually involved in the securities law violations. Plaintiffs correctly

respond that standing must be determined from the pleadings rather than from the liability actually imposed.

The pleadings in this case establish plaintiffs' standing. The Constitution's "case or controversy" requirement (U.S. Const. art. 3, § 2) with respect to standing is met when plaintiffs allege that they have suffered some injury as a result of defendants' illegal conduct. *Linda R.S. v. Richard D.*, 410 U.S. 614, 617, 93 S.Ct. 1146, 1148, 35 L.Ed.2d 536 (1973). *See also Dupree v. United States*, 559 F.2d 1151, 1153 (9th Cir.1977). Plaintiffs here alleged a series of securities violations and a conspiracy that caused them damages. Defendants may be liable for all the actions of their co-conspirators, even those that occurred before the particular defendants joined the conspiracy. *United States v. Saavedra*, 684 F.2d 1293 (9th Cir. 1982); *United States v. Traylor*, 656 F.2d 1326, 1337 (9th Cir. 1981). *See also In re Equity Funding Corp.*, 416 F.Supp. 161, 180 (C.D. Cal.1976). Moreover, the factual issues denominated in the pretrial order in this case clearly covered the defendants' participation as aiders and abettors and as conspirators for a period beginning in 1960. The jury found all appellants liable for conspiracy beginning in 1963. The jury was further instructed at the damage phase that it could hold each defendant liable for all damages which accrued during the conspiracy period.

The jury chose, however, to assess damages against each defendant (other than C. Arnholt for the period the jury found that each was actually involved in C. Arnholt's deceptions. In this way, the jury found Helen, Shannon, and Toft liable only to purchasers who bought their shares after 1968; the named plaintiffs are therefore not able to recover from these defendants.

[12] This result does not mean, however, that the named plaintiffs lacked standing. These plaintiffs had standing to

pursue the action in the first instance. Standing ordinarily does not depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularized injury," *Warth v. Seldin*, 422 U.S. 490, 508, 95 S.Ct. 2197, 2210, 45 L.Ed.2d 343 (1975). As we have stated, "failure of proof as to the named plaintiffs would not bar maintenance of the class action or entry of judgment awarding relief to the members of the class." *Gibson v. Local 49, Supercargoes & Checkers, Etc.*, 543 F.2d 1259, 1263 (9th Cir. 1976). *See also East Texas Motor Freight System v. Rodriquez*, 431 U.S. 395, 406 n. 12, 97 S.Ct. 1891, 1897, 1898, 52 L.Ed.2d 453 (1977), where the Court, *citing Franks v. Bowman Transportation Co.*, 424 U.S. 747, 752, 96 S.Ct. 1251, 1258, 47 L.Ed.2d 444 (1976), stated that "[p]rovided the initial certification was proper and decertification not appropriate, the claims of the class members would not need to be mooted or destroyed because subsequent events of the proof at trial had undermined the named plaintiffs' individual claims." All plaintiffs had standing to pursue their section 10(b) claims against the defendants.

C. *Adequacy of Class Representation*

[13, 14] A different question is presented with respect to whether the named plaintiffs were appropriately certified as adequate class representatives under Rule 23(a). A district court's determination as to adequacy of representation will be overturned only if the district court abused its discretion. *Pattillo v. Schlesinger*, 625 F.2d 262 (9th Cir. 1980); *Clark v. Watchie*, 513 F.2d 994 (9th Cir. 1975). There was no abuse of discretion in this case. Insofar as the defendants argue that the named representatives are not typical of the class members who purchased shares later, their position is

contrary to *Blackie v. Barrack*, 524 F.2d 891, 902, 911 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976). The suit was properly conducted as a class action.

IV.

*Sufficiency of the Evidence — Section 10(b) Claims*

Each defendant was found liable for at least one secondary violation of section 10(b) of the Securities Exchange Act. Helen, Shannon, Toft, John, and FNFC were found liable under an aiding and abetting theory. C. Arnholt, Helen, Shannon, and Toft were found to have conspired to violate section 10(b). Helen and Shannon were found secondarily liable as control persons of a primary section 10(b) violator. The district court limited compensatory damages to the greatest amount assessed under any one count. Because the amounts awarded under the separate section 10(b) secondary counts were identical (and equal to or larger than the amounts awarded under the pendent claims), we need only sustain one secondary violation of section 10(b) as to each defendant in order to sustain the judgment.[9] We conclude that all defendants were properly found liable as aiders and abettors.

[15] The elements of a cause of action for aiding and abetting under section 10(b) are: (1) the existence of an independent primary wrong; (2) actual knowledge by the alleged aider and abettor of the wrong and of his or her role in furthering it; and (3) substantial assistance in the wrong. *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C.

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[9]Because C. Arnholt does not appeal the adverse verdict under section 93 of the Bank Act, and damages awarded against C. Arnholt under the Bank Act count were greater than damages awarded under any other count, the judgment against him can therefore be sustained without addressing his conspiracy liability under 10(b). His violation of 10(b) is, of course, relevant to consideration of the other defendants secondary liability.

Cir.), *cert. denied*, 449 U.S. 919, 101 S.Ct. 317, 66 L.Ed.2d 146 (1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799 (3d Cir.), *cert. denied*, 439 U.S. 930, 99 S.Ct. 318, 58 L.Ed.2d 323 (1978); *Rochez Brothers, Inc. v. Rhoades*, 527 F.2d 880, 886 (3d Cir. 1975); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir. 1975); *In re Gap Stores Securities Litigation*, 457 F.Supp. 1135, 1143-44 (N.D. Cal. 1978); *In re Equity Funding Corp.*, 416 F.Supp. at 180. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U.Pa.L.Rev. 597, 627-38 (1972).

[16] The first element is satisfied by the primary violation of section 10(b) by C. Arnholt. His fraudulent loans, material omissions, nondisclosures, and positive misrepresentations clearly constituted violations of section 10(b) and Rule 10b-5. The jury was properly instructed on the elements of a 10(b) and 10b-5 cause of action, and there is ample record evidence to support these violations.

The existence of the second and third elements as to Helen, Shannon, and Toft is also supported by the record. Although Helen testified that she never dicussed USNB with C. Arnholt, the record shows that Helen had numerous business dealings with USNB, including transactions in which she received loans at non-market terms and acquired real property at minimal cost. There is sufficient evidence from which the jury could conclude that she knew that potential investors were being deceived by C. Arnholt. Taken in the light most favorable to the plaintiffs, the evidence also adequately supports the jury's finding that Helen knowingly provided substantial assistance in the fraud. *See IIT*, 619 F.2d at 923-28; *Monsen*, 579 F.2d at 799-801; *cf. Investors Research Corp.*, 628 F.2d at 178.

[17] Helen asks us to declare that there can be no liability premised on aiding and abetting a violation of section 10(b). Such a result has been suggested as a possible consequence of the United States Supreme Court decisions in *Touche Ross & Co. v. Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979) and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). *See Securities & Exchange Comm. v. Seaboard Corp.*, 677 F.2d 1301, 1311 n. 12 (9th Cir. 1982) (dictum); Fischel, *Secondary Liability under §10(b) of the Securities Act of 1934*, 69 Cal.L.Rev. 80 (1981). However, the Supreme Court has not yet seen fit to follow that suggestion. Further, other circuits have stated that aider and abettor liability under section 10(b) continues to exist. *See Dirks v. SEC*, 681 F.2d 824 (D.C. Cir. 1982); *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir.), *cert. denied*, ___ U.S. ___, 103 S.Ct. 213, 72 L.Ed.2d ___ (1982); *Stokes v. Lokken*, 644 F.2d 779, (8th Cir. 1981); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.), *cert. denied*, 439 U.S. 930, 99 S.Ct. 318, 58 L.Ed.2d 323 (1978). Our own decision in *Strong v. France*, 474 F.2d 747 (9th Cir. 1973) discusses the methods of establishing aider and abettor liability. In the absence of any authority or compelling reasons for holding that aider and abettor, liability no longer exists, we hold that it remains a viable part of securities regulation.

[18] Shannon and Toft also argue that aider and abettor liability cannot be applied to them they were under no duty to disclose to USNB shareholders. *Chiarella v. United States*, 445 U.S. 222, 100 S.Ct. 1108, 63 L.Ed.2d 348 (1980). This contention blurs the distinction between primary and secondary violations of section 10(b). While C. Arnholt's duty to disclose arises from his position in the bank and his relationship to the shareholders, *id.* at 227-28, 100 S.Ct. at 1114, the secondary violator's duty arises from "knowing

assistance of or participation in a fraudulent scheme." *Strong v. France*, 474 F.2d 747, 752 (9th Cir. 1973) (quoting *Anderson v. Francis I. duPont and Co.*, 291 F.Supp. 705, 709 (D.Minn. 1968)).[10] The record clearly shows that the jury was presented with sufficient evidence surrounding transactions involving both Shannon and Toft from which it could find knowing assistance or participation.

V

*The Westgate Instructions*

[19] The district court instructed the jury to give conclusive effect to certain findings made in the Westgate California Corporation bankruptcy proceedings regarding John's involvement in fraud, including a finding that John was "an integral part of the fraud involving Westgage California Corporation and the United States National Bank . . ." This court, however, after the trial in this case, reversed the Westgate bankruptcy decision, noting that "the record as presented to us is inadequate to support a determination that J.A. Smith behaved inequitably." *Westgate-California Corp. v. First National Finance Corp.*, 650 F.2d 1040, 1044 n. 1 (9th Cir. 1981). We now know, therefore, that the *Westgate* findings were not entitled to the conclusive effect that the jury was instructed to give them, and that the instruction was erroneous. *Butler v. Eaton*, 141 U.S. 240, 242, 11 S.Ct. 985, 986, 35 L.Ed. 713 (1891). (9th Cir. 1980); Restatement (Second) of Judgments §16, comment c (1982) (when a later judgment is based upon an earlier judgment

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[10]Other cases involving aider and abettor liability have also recognized that such liability exists even when the secondary violator owes no duty to the plaintiffs. *See, e.g., Sirota*, 673 F.2d at 575 (existence or non-existence of duty on part of aider and abettor only relates to degree of scienter needed to prove violation — less scienter suffices when duty present); *IIT*, 619 F.2d at 927 (same); *Monsen*, 579 F.2d at 800 (conscious aiding and abetting liability not predicated on existence of duty).

which is set aside or reversed, "[t]he court should then normally set aside the later judgment").

The plaintiffs correctly point out that the record nevertheless contains evidence which would independently support the verdict against John and FNFC. The problem is, however, that it is impossible to evaluate what the jury might have done, had it not been instructed to give conclusive weight to the *Westgate* findings. We recently held that an erroneous instruction in a civil case was harmless error where there was ample evidence for the jury's conclusion. We stated:

> An erroneous ruling which relates to the substantial rights of a party, is grounds for reversal unless it affirmatively appears from the whole record that it was not prejudicial. *McCandless v. United States*, 298 U.S. 342, 347-48, 56 S.Ct. 764, 766, 80 L.Ed. 1205 (1936). This is especially true of an error in jury instructions. *Fillippon v. Albion Vein Slate Co.*, 250 U.S. 76, 82, 39 S.Ct. 435, 437, 63 L.Ed. 853 (1919).

*Chancellier v. Federated Dept. Stores*, 672 F.2d 1312, 1316 (9th Cir. 1982). Applying that standard, we cannot hold that the error here is harmless. The verdicts against John A. Smith and FNFC must therefore be reversed.

## VI

## *Damages*

Damages were determined by the jury in a proceeding separate from the determination of liability. Each defendant claims a number of errors in the damages phase of the trial.

[20, 21] Defendants first argue that the calculation of damages was speculative. Defendants are correct in asserting that the plaintiff in a securities fraud action has the burden of proving that damages flowed from the alleged

injury. *Rochez Brothers v. Rhoades*, 527 F.2d 891, 894 (3d Cir. 1975). *See Mills v. Electric Auto-Lite*, 396 U.S. 375, 388, 90 S.Ct. 616, 623, 24 L.Ed.2d 593 (1969) ("damages should be recoverable only to the extent they can be shown"). Although damages need not be proved to a mathematical certainty, "sufficient facts must be introduced so that a court can arrive at an intelligent estimate without speculation or conjecture." 527 F.2d at 895. *See also LeLandais & Company v. MDS Atron*, 543 F.2d 421, 424 & n. 5 (2d Cir.), *cert. denied*, 429 U.S. 1062, 97 S.Ct. 786, 50 L.Ed.2d 777 (1976) (failure to adequately show damages prevents recovery).

[22] In this case, a special master, appointed by the trial judge, sent questionnaires to USNB shareholders requesting various information, including the date they purchased their shares. Forty-two percent of the questionnaires were returned. From the information provided, the special master prepared schedules based both upon the actual responses and upon extrapolations from them.

We are persuaded that the porcedures used by the trial court do not constitute reversible error. The special master's report was intended to provide information from which the jury could calculate injury to the plaintiff class as a whole. The questionnaires, which included information about dates of share purchases, sufficiently served this purpose. Further, as noted above, the jury was specifically instructed to find damages based upon purchases of stock. The jury was instructed that plaintiffs were required to prove that damages were suffered as "a proximate result of the alleged misleading statements or omission, and the purchase of stock

in reliance to [sic] that."[11] It may well be that not all class members will make claims against the defendants. If there are excess damage funds after distribution, the district court should consider any feasible methods of returning that excess, with appropriate interest, to defendants.

Shannon and Toft argue that the procedure was fatally defective because the damages were not awarded with respect to the specific time periods for which the various defendants were found liable. This argument has no basis in fact. The jury was provided with damages forms which specifically indicated the beginning and ending dates of each defendant's liability as determined in the liability phase of the trial. The jury was well aware of the time frame of each defendant's liability.

[23] Defendants next argue that no damages can be awarded for conduct after 1968 because plaintiffs' expert testified that USNB stock was worthless as of that date. This argument misconstrues the basis for defendants' liability. Defendants were found liable for failing to disclose material information which would have affected an inves-

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[11]Proof of each plaintiff's reliance on the misrepresentations or omissions is not a prerequisite to recovery. As we stated in *Blackie v. Barrack*, 524 F.2d 891, 905 (9th Cir. 1975), *cert. denied*, 429 U.S. 816, 97 S.Ct. 57, 50 L.Ed.2d 75 (1976), "[t]he amount of damages is invariably an individual question and does not defeat class action treatment. . . . Individual questions of reliance are likewise not an impedement — subjective reliance is not a distinct element of proof of 10b-5 claims . . . ."

Further, if omissions or nondisclosures meet the standards of materiality to a reasonable investor, *see TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2133, 48 L.Ed.2d 757 (1976); *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266 (9th Cir. 1979), causation and reliance can be assumed. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972); *Blackie*, 524 F.2d at 906.

With respect to the pendent claims, defendants do not contend that a showing of reliance was necessary, and, if so, that it was lacking in this case.

tor's decision whether to purchase USNB stock. The worthlessness of USNB stock actually evidences the effect of this failure; damages were, in fact, created by the non-disclosures.

Defendants' final argument on compensatory damages is that the district court improperly included certain shareholders in the plaintiff class. These allegedly improper class members were all non-California purchasers, the Franklin National Bank and the Westgate California Insurance Company. Each of the challenged members will be treated in turn.

[24] Prior to the district court's instructions on damages, defendants argued that the class eligible for recovery on the pendent claims should not include out-of-state purchasers. Their theory was that non-California purchasers should not be permitted to recover for causes of action based on California law. The district court denied defendants' motion because the issue, raised for the first time some six years after the inception of the suit, had not been introduced in a timely manner.

Even assuming that the district court erroneously denied defendants' motion on grounds of untimeliness, defendants have not demonstrated grounds for barring the out-of-state plaintiffs from obtaining recovery on the pendent claims. The district court would have been required to apply the substantive law of the state in which it sits, including choice-of-law rules. *Gee v. Tenneco, Inc.*, 615 F.2d 857, 861 (9th Cir. 1980). Defendants have failed to show, as required by California law, that the law of other states relating to the pendent claims is significantly different from California's and, more importantly, that the interests of other states would be impaired by application of California law of these non-resident plaintiffs. *Id.*; *Offshore Rental Co. v. Continental Oil Co.*, 22 Cal.3d 157, 164-66, 583 P.2d 721, 725-27, 148 Cal.Rptr. 867, 871-73 (1978); *Hurtado v. Superior*

*Court*, 11 Cal.3d 574, 579-80, 522 P.2d 666, 669, 114 Cal.Rptr. 106, 109 (1974). There appears no other reason to exclude the out-of-state purchasers from participating in pendent claims arising from conduct in California.

[25] Franklin National Bank was the pledgee of USNB stock. Defendants argue that a pledge of stock is not a "purchase or sale" for purposes of section 10(b) and Rule 10b-5. Plaintiffs rely on *Rubin v. United States*, 449 U.S. 424, 101 S.Ct. 698, 66 L.Ed.2d 633 (1981), which held that a pledge constitutes an "offer or sale" for purposes of section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a).

Defendants have offered no persuasive reason why a pledge of shares of stock should not similarly satisfy the purchase or sale requirement of section 10(b) and Rule 10b-5. We think this result flows logically from *Rubin*. *Cf. Marine Bank v. Weaver*, 455 U.S. 551, ___, 102 S.Ct. 1220, 1222 n. 2, 71 L.Ed.2d 409 (1982) (*Rubin* held that "a pledge of stock is equivalent to a sale for the purposes of the antifraud provisions of the federal securities laws"). As the Court stated in *Rubin:*

> The economic considerations and realities present when a lender parts with value and accepts securities as collateral security for a loan are similar in important respect to the risk an investor undertakes when purchasing shares. Both are relying on the value of the securities themselves, and both must be able to depend on the representations made by the transferor of the securities, regardless of whether the transferor passes full title or only a conditional and defensible interest to secure repayment of a loan.

449 U.S. at 431, 101 S.Ct. at 702 (footnote omitted). This language fully supports our conclusion that Franklin National Bank, even though it had less than a complete interest

in the pledged shares, should be able to remain in the plaintiff class and recover damages for violations of section 10(b) and Rule 10b-5.

[26] The same result is not appropriate for Westgate California Insurance Company. C. Arnholt was the controlling shareholder of that company. Defendants argue that it would be inequitable for a company controlled by the central defendant in a lawsuit to recover as a member of the plaintiff class. We agree. All defendant shareholders were expressly excluded from the plaintiff class. Although Westgate was not a defendant, we think the same principle should apply to an entity that is so closely related to a defendant. Westgate should not recover damages. On remand, the district court should consider whether the inclusion of Westgate[12] in class schedules on damages measurably effected the amount of damages awarded and whether a corresponding reduction in damages is appropriate.

[27, 28] Finally, Shannon, Toft, and Helen argue that the punitive damages awards were excessive. We cannot agree. This court will not overturn an award of punitive damages "unless it appears that the jury was influenced by passion or prejudice." *Glovatorium, Inc. v. NCR Corporation*, 684 F.2d 658 at 663 (9th Cir. 1982); *Moore v. Greene*, 431 F.2d 584, 593-94 (9th Cir. 1970). Neither the amount of punitive damages awarded in relation to the compensatory damages nor any other evidence indicates that the jury was influenced by passion or prejudice. The jury was

---

[12]John's argument on this issue refers to shares held by Westgate *Life* Insurance Co., a separate entity from Westgate California Insurance Co. The record shows that the inclusion of shares held by Westgate California Insurance Co. was called into question during examination of the special master, and we assume that these shares are the subject of the present dispute. Westgate California Insurance Co. owned over 41,000 shares of USNB.

correctly instructed that punitive damages should only be awarded if the jury believed that the defendants acted with malice. The term malice was correctly defined. The award of punitive damages will not be disturbed.

## VII

## *Conclusion*

The judgments against all defendants except John and FNFC are affirmed. The judgments against John and FNFC are reversed.

The district court must design and execute a claims procedure consistent with this opinion. As recognized by the district court's amendment to judgment, amounts already paid by settling defendants are to be offset. The class of eligible plaintiffs will not include Westgate California Insurance Company.

Affirmed in part; Reversed in part; Remanded.

## APPENDIX B.

§ 93. Violations of provisions of chapter; forfeiture of franchise; personal liability of directors; civil money penalty

(a) If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

(b)(1) Any national banking association which violates, or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such association who violates any of the provisions of this title, or any of the provisions of section 92a of this title, or any regulation issued pursuant thereto, shall forfeit and pay a civil money penalty of not more than $1,000 per day for each day during which such violation continues. The penalty may be assessed and collected by the Comptroller of the Currency by written notice. As used in the section, the term "violates" includes without any limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

(2) In determining the amount of the penalty the Comptroller shall take into account the appropriateness of the

penalty with respect to the size of financial resources and good faith of the association or person charged, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

(3) The association or person assessed shall be afforded an opportunity for agency hearing, upon request made within ten days after issuance of the notice of assessment. In such hearing all issues shall be determined on the record pursuant to section 554 of Title 5. The agency determination shall be made by final order which may be reviewed only as provided in paragraph (4). If no hearing is requested as herein provided, the assessment shall constitute a final and unappealable order.

(4) Any association or person against whom an order imposing a civil money penalty has been entered after agency hearing under this section may obtain review by the United States court of appeals for the circuit in which the home office of the bank is located, or in the United States Court of Appeals for the District of Columbia Circuit, by filing a notice of appeal in such court within thirty days from the date of such order, and simultaneously sending a copy of such notice by registered or certified mail to the Comptroller. The Comptroller shall promptly certify and file in such court the record upon which the penalty was imposed, as provided in section 2112 of Title 28. the findings of the Comptroller shall be set aside if found to be unsupported by substantial evidence as provided by section 706(2)(e) of Title 5.

(5) If any association or person fails to pay an assessment after it has become a final and unappealable order, or after the court of appeals has entered final judgment in favor of the agency, the Comptroller shall refer the matter to the Attorney General, who shall recover the amount assessed by action in the appropriate United States district court. In

such action the validity and appropriateness of the final order imposing the penalty shall not be subject to review.

(6) The Comptroller may, in his discretion, compromise, modify, or remit any civil money penalty which is subject to imposition or has been imposed under this section.

(7) The Comptroller shall promulgate regulations establishing procedures necessary to implement this subsection.

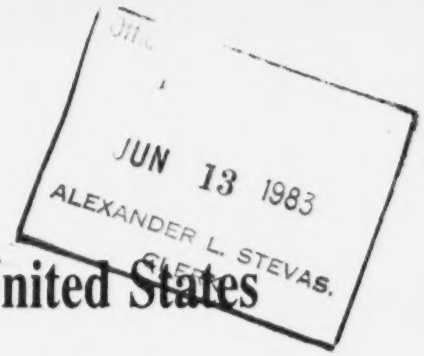
(8) All penalties collected under authority of this section shall be covered into the Treasury of the United States.

## APPENDIX C.

### § 78j. Manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.




No. 82-1982
IN THE

# Supreme Court of the United States

October Term, 1982

CAROL SMITH SHANNON and PHILIP A. TOFT,
*Petitioners,*

*vs.*

FRED H. HARMSEN, *et al.*,
*Respondents.*

**On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.**

## SUPPLEMENTAL APPENDIX

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## SUPPLEMENTAL APPENDIX D.

### Judgment.

United States District Court, Southern District of California.

Fred H. Harmsen, Ken Hansen, Samuel Rosenberg and James P. Young, et al., Plaintiffs, vs. C. Arnholt Smith, et al., Defendants. Consolidated Civil Actions Nos. 73-460-E and 74-345-E.

Filed: January 2, 1980.

The claims of named plaintiffs FRED H. HARMSEN, KEN HANSEN, SAMUEL ROSENBERG and JAMES P. YOUNG, and of the class which they represent, against defendants C. ARNHOLT SMITH, HELEN SMITH, CAROL SMITH SHANNON, PHILIP A. TOFT, M. J. COEN, JOHN A. SMITH, FIRST NATIONAL FINANCE CORPORATION, U. S. HOLDING COMPANY, SAN DIEGO PADRES and FIRST CALIFORNIA COMPANY, came on for jury trial on August 6, 1979 for the liability phase, and, before the same jury, on December 6, 1979 for the damage phase. The issues having been duly tried, and the jury having rendered its liability verdict on October 12, 1979 and its damage verdict on December 21, 1979,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that judgment is as follows:

1. As to defendant C. ARNHOLT SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent, on the following counts and in the following amounts:

| | |
|---|---|
| Count I | $12,298,708.11 |
| Count II | $12,061,417.72 |
| Count V | $ 8,689,021.25 |
| Count VI | $12,061,417.72 |
| Count VII | $11,614,538.21 |
| Count VIII | $11,085,494.77 |

| | |
|---|---|
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII, VIII and IX only) | $11,000,000.00 |

2. As to defendant HELEN SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent, on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |
| Punitive Damages (Counts VI, VII and IX only) | $ 750,000.00 |

3. As to defendant CAROL SMITH SHANNON, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 6,241,170.02 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 6,241,170.02 |
| Count IX | $ 5,858,660.91 |

| | |
|---|---|
| Punitive Damages (Counts VI, VII and IX only) | $ 3,000,000.00 |

4. As to defendant PHILIP A TOFT, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $ 8,689,021.25 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 8,689,021.25 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII and IX only) | $ .00 |

5. As to defendant M. J. COEN, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count III | $ 6,241,170.02 |
| Count IV | $ 6,241,170.02 |
| Count V | $ 8,689,021.25 |
| Count VI | $ 6,241,170.02 |
| Count VII | $ 8,689,021.25 |
| Count IX | $ 8,083,508.79 |
| Punitive Damages (Counts VI, VII and IX only) | $ 3,000,000.00 |

6. As to defendant JOHN A. SMITH, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $11,614,538.21 |
| Count VI | $11,614,538.21 |
| Count VII | $11,614,538.21 |
| Count IX | $10,722,476.62 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |

7. As to defendant FIRST NATIONAL FINANCE CORPORATION, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on the following counts and in the following amounts:

| | |
|---|---|
| Count IV | $ 2,861,957.38 |
| Count VI | $ 2,861.957.38 |
| Count VII | $ 2,861,957.38 |
| Count IX | $ 2,868,933.92 |
| Punitive Damages (Counts VI, VII and IX only) | $ 1.00 |

8. As to defendant U. S. HOLDING COMPANY, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

9. As to defendant SAN DIEGO PADRES, judgment against said defendant and in favor of the named plaintiffs

and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

10. As to defendant FIRST CALIFORNIA COMPANY, judgment against said defendant and in favor of the named plaintiffs and the class which they represent on all counts in the amount of $12,298,708.11 in compensatory damages, and $1.00 in punitive damages.

11. As to all defendants, judgment against all defendants and in favor of the named plaintiffs and the class which they represent for the costs of suit herein.

Dated 1/2/80.

/s/ William B. Enright
WILLIAM B. ENRIGHT
Judge, U.S. District Court

**Amendment to Judgment.**

United States District Court, Southern District of California.

Fred H. Harmsen, et al., Plaintiffs, v. C. Arnholt Smith, et al., Defendants. Civil Nos. 73-460-E, 74-345-E.

Filed: January 16, 1980.

Upon motion of defendants, the court hereby amends its Judgment in this case, entered January 4, 1980, to add the following concluding paragraph:

> "The liability of each defendant is no greater than the largest sum such defendant has been found liable for as to any one count, plus the amount of any punitive damages for that particular defendant. Any payment by any defendant shall reduce by like amount the amount of liability of every other defendant, except punitive damages which are the sole responsibility of the particular defendant against whom punitive damages have been assessed."

This paragraph shall be deemed to be incorporated into the judgment entered January 4, 1980.

It is so ordered.

DATED: January 16, 1980.

/s/ William B. Enright, Judge
WILLIAM B. ENRIGHT, Judge
United States District Court

Copies to:
Plaintiffs
Defendants

Office - Supreme Court, U.S
FILED
JUL 6 1983

No. 82-1982

# In the Supreme Court

OF THE

# United States

OCTOBER TERM, 1982

CAROL SMITH SHANNON and PHILIP A. TOFT,
*Petitioners,*

vs.

FRED H. HARMSEN, et al.,
*Respondents.*

## BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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## QUESTIONS PRESENTED FOR PREVIEW

1. Whether the Ninth Circuit properly determined that the National Bank Act and the federal securities laws both provide remedies for improper nondisclosures relating to the purchase of bank stock.

2. Whether the Ninth Circuit properly determined that the class certification procedures followed by the trial court were not improper and that plaintiffs have standing to sue.

3. Whether the Ninth Circuit properly applied standards for determination of secondary liability under Section 10(b) which are entirely consistent with, and in some instances more stringent than, standards set out in prior case law.

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No. 82-1982

# In the Supreme Court

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OCTOBER TERM, 1982

CAROL SMITH SHANNON and PHILIP A. TOFT,
*Petitioners,*

VS.

FRED H. HARMSEN, et al.,
*Respondents.*

## BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Respondents, plaintiffs below, respectfully urge this Court to deny the petition of Carol Smith Shannon ("Shannon") and Philip A. Toft ("Toft") for writ of certiorari. These petitioners point to no conflict between the decision of the Ninth Circuit in this case and the decisions of this Court or of any other circuit courts. Nor do petitioners demonstrate any impropriety in the Ninth Circuit's resolution of the issues before it.

## I

## STATEMENT OF THE CASE

This petition is brought by Carol Smith Shannon, daughter of co-defendant C. Arnholt Smith,[1] and Philip A. Toft, a close business associate of Mr. Smith. Both Shannon and Toft were found liable for aider/abettor liability and conspiracy liability under Section 10(b) of the Securities Exchange Act of 1934, and fraud, conspiracy to defraud and conspiracy to abuse control under California state law principles. In addition, Shannon was found liable for control person liability under Section 20(a) of the '34 Act.

The facts which were presented to the jury arise out of the operation and collapse of United States National Bank on October 18, 1973 and the direct loss to the shareholders of the bank. As petitioners concede, C. Arnholt Smith controlled USNB from 1933 until 1973. When the bank collapsed in 1973, USNB had between $150 and $200 million in uncollectible loans (RT 2235-37). The background of USNB and how it was used by the defendants collectively is set out in respondents' Brief in Opposition to Helen Smith's Petition for Writ of Certiorari (No. 82-1980) and, for the sake of brevity, will not be repeated here.

---

[1]C. Arnholt Smith was and is represented by the same counsel as Shannon and Toft. The petition virtually admits the very violations alleged against C. Arnholt Smith (Petition, p. 3), although at trial he exercised his right to remain silent pursuant to the Fifth Amendment to the U.S. Constitution. C. Arnholt did not petition to this Court for relief, although the exclusivity of the National Bank Act is an argument that affects only him directly. As a threshold issue, this Court may find it inappropriate to consider the issues raised by these petitioners because the individual most directly affected has not chosen to seek review.

The roles played by Shannon and Toft will be summarized below.

**A. Role of Carol Smith Shannon**

Petitioners concede that Carol Smith Shannon diverted loan proceeds from one Smith-controlled entity to another, acting in concert with C. Arnholt Smith. Petition, p. 3. Petitioners fail, however, to mention the many other self-dealing and/or self-enriching transactions Shannon engaged in at the expense of the Bank and its shareholders. These other activities demonstrated her *scienter* and cemented her liability.

**(1) Corporate Director of Controlled Entities**

Carol Smith Shannon sat on the Board of Directors of Westgate California Corp. ("Westgate" or "WCC") and attended its meetings. (RT 4979) During her tenure on the Board, WCC was the recipient of millions of dollars of USNB loan funds that were never recorded on Westgate's books. (RT 4214-4215)

Shannon also sat on the Board of Directors of Air California, a Westgate subsidiary. (RT 4983-84). During her time on that Board, approximately $4 million in credit was illegally shifted to British Columbia Investment Company ("BCIC"; see p. 1, EXH. 169 and 170), a company which, as noted earlier, eventually wound up owing USNB over $100 million in uncollectible funds. While Shannon denied all knowledge of these illicit transfers (RT 4988), the jury concluded otherwise from all the evidence of her involvement.

Shannon was also a director of U.S. Holding Co., a Smith family owned entity (RT 4980). Thousands of dollars of loan proceeds were directed to this company (EXH. 191).

**(2) Loan Transactions with USNB**

Shannon was involved in self-dealing and fraudulent debt rollovers through her sole ownership of Valley Lane Farms, Inc. (VLF). VLF was established in 1969 or 1970 with a $300,000 real estate loan from USNB, negotiated by Shannon's father. (RT 4966-67; 4976-77) Shannon's company, VLF, was the sole owner of United City, Inc. (RT 5027), Vista San Luis Rey (RT 5020), South Coast Financial Corp. (RT 5021), Underwriters' Insurance Agency (RT 5042) and other subsidiaries. At trial, Shannon testified that some of VLF's subsidiaries were merely "corporate shells." (RT 5022)

Both VLF and its subsidiaries were involved in numerous fraudulent transactions with USNB. For example, in 1972 Westgate California Realty, Inc. and Wescal Properties, Inc. were the collective recipients of $8,600,000 of USNB funds, ostensibly loaned for the purpose of rewriting existing debts and providing working capital. These funds were secretly deposited in Westgate Plaza Cash Collateral Account #3, set up by C.A. Smith and Philip Toft. The money was then diverted to various other entities, with VLF receiving a total of $42,000. The FDIC estimates that more than $4 million of these funds are uncollectible (Exh. 191-50; 191-56).

In 1971, United City, Inc., a VLF entity, retired an existing $1,617,000 obligation to USNB with funds provided by Sovereign State Capital ("SSC"). (Exh. 191-61.) The

source of much of SSC's funds was a USNB loan to Wescal, which had been remitted to SSC by Philip Toft. (*Id.*) The effect of this transaction was to allow United City, Inc. to retire an existing obligation to USNB with funds obtained from the bank itself—a flagrant debt rollover. Since Shannon was the *sole owner* of United City, Inc., the jury could reasonably have inferred her knowledge of this transaction.

In addition to benefitting directly from USNB loans, Shannon's subsidiaries also served as a conduit for illicit loan transfers themselves. On June 4, 1969, C.A. Smith approved a $350,000 unsecured loan to Shannon's wholly-owned Underwriters' Insurance Agency (UIA) (RT 2291-92; Exh. 191-74). Although there was no indication on the bank records that the loan would be used by entities other than UIA (RT 2295), Shannon's company immediately transferred the money to Sovereign State Capital, a Smith family corporation (Exh. 191-74).

Beyond participating as a corporate director and through her own companies in the USNB loans, Shannon was also personally involved in conduit loan transactions. At trial, it was shown that she served as a willing conduit (to use her own words, a "nominee"; RT 5004) for the secret transfer of $150,000 from National Marine Terminals, Inc. (NMT)[2] to First California Corp., which was owned by M.J. Coen (RT 5006). Although Shannon denied any personal involvement in the transaction, she did admit knowledge of the scheme under which NMT issued a $150,000

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[2]NMT was a Smith family entity, a subsidiary of SSC. At the time of the bank examiner's report in 1972, NMT owed $5,143,225 to USNB (Exh. 170, page 2-A-1).

loan to Shannon, who then remitted the balance to First California. (RT 5002-5006)

**(3) Personal Benefits from USNB**

Shannon also derived personal benefit from her association with USNB. One such example was in 1971, when she acquired through VLF approximately 160 acres of orange groves from Calafia Land Corporation, in return for a promissory note in the amount of $750,000. (RT 5030-31; Exh. 434). *Eleven* days later, this note was transferred to USNB and booked in Shannon's name for only $500,000. (RT 2241). The result of this transaction was to reduce Shannon's debt immediately from $750,000 to $500,000—an outright gift of $250,000. Moreover, Shannon paid only $50,000 to the bank on the debt and has made no further payments. (RT 2241-43; 5035-38; Exh. 435) The land is still in her name and is now worth over $1 million (RT 5087).

Shannon's primary valuable asset, besides her various corporations, is Valley Lane Farms. Having bought this on a $300,000 loan from USNB through C.A. Smith in 1969, Shannon sold 17 or 18 acres out of a total of 60 for $1,450,000 (CR 8540). Shannon estimates the value of the remaining 42 acres to be $3 or $4 million dollars (RT 8541). This does not include the assets in other corporations owned by Shannon. Her companies were recipients of millions of dollars of loans, all undisclosed to the shareholders of USNB and now uncollectible. (Exh. 191; 119).

*None* of these improper activities was disclosed to the shareholders (Exh. 119).

**B. Role of Philip A. Toft**

Toft joined WCC in 1962 as Vice-President of Finance and rose through the ranks until he was named President of WCC in 1972 (RT 5241-44). Toft was personally involved in the administration of the financial affairs of WCC from 1962 until the time of WCC's bankruptcy. He was a director of all of WCC's subsidiaries (RT 5245). At trial, Toft testified that he assisted C.A. Smith in setting up the secret "cash collateral" or "administrative" accounts which were used to funnel loans to entities other than those named on bank records. (RT 5253; 5276-77). Indeed, many of the illicit loan transfers bore Toft's own personal signature. (Exh. 191) The extent of Toft's intimate involvement in the fraud was established by bank attorney Hugh Friedman, who testified that, in 1973, he was called into C.A. Smith's office where both Toft and C.A. Smith candidly admitted that they had been taking loans in the name of Westgate subsidiaries without bothering to disclose the transactions on the corporation's own books. (RT 4954, 4961-62).

The jury found against Toft on all counts which involved his acting in concert with C.A. Smith. During proceedings before the Ninth Circuit, Toft virtually admitted his liability. At page 13 of his Opening Brief on Appeal, he stated:

> In 1968 Toft was an officer and director of Westgate which Smith controlled. Subsequent to March 1, 1968, Toft at Smith's suggestion secured loans for Westgate's subsidiaries. On some occasions at Smith's suggestion the money was not used for the purpose stated in the loan application but was reloaned to another Smith controlled entity.

### C. Conclusion

Petitioners' arguments in the instant proceedings must be considered in the context of the facts established at trial and admitted by petitioners in this Court. In essence, petitioners' primary theory in this Court is that they should be immune from liability under the federal securities laws, because the National Bank Act provides a limited remedy not against them, but against some *other* defendants. The Ninth Circuit properly rejected this claim.

## II

## REASONS REVIEW SHOULD BE DENIED

### A. The Ninth Circuit's Analysis of the National Bank Act Is Consistent with Prior Decisions of This Court

This Court has held that the National Bank Act provides a limited private remedy against the directors of a national bank. *Chesbrough v. Woodworth,* 244 U.S. 72, 76 (1917). These actions, under Section 93 of the Act, are limited to violations of "any of the provisions of" Chapter 2, Title 12 of the U.S. Code (Banks and Banking) and may only be brought against directors of the Bank.

Petitioners Shannon and Toft argue that the National Bank Act remedy is exclusive of all other remedies against directors and non-directors alike:

> **Having employed the exclusive remedy available against the bank directors, the lower court was without jurisdiction to entertain an action by the plaintiffs against any of the non-director defendants, such as Shannon and Toft, under the federal securities laws or pendent state claims based upon the same alleged activities. (Petition, p. 10)**

They thus claim complete immunity for themselves, based upon the availability of a limited remedy against others. The Ninth Circuit correctly rejected this unprecedented position.[3]

The Court first discussed the relationship between liability under the National Bank Act and pendent state law claims. *Harmsen v. Smith,* 693 F.2d 932, 939 (9th Cir. 1982), attached as Appendix "A" to Petition, p. 8. The Court noted that C. Arnholt Smith (a bank director) could only be liable for pendent state claims "based on conduct outside the reach of the Bank Act" (Appendix "A", p.9), citing *Yates v. Jones National Bank,* 206 U.S. 158 (1907). The Ninth Circuit found that the pendent claims did, as a matter of fact, involve claims outside the scope of Section 93:

> The complaint alleges, and the record clearly shows that C. Arnholt was engaged in fraudulent activity that went far beyond the narrow range of conduct prohibited by the Act. The district court judge specifically so held in his denial of defendants' motion for judgment n.o.v., and we agree. We thus conclude that the district court acted properly in considering the pendent claims against C. Arnholt. (Appendix "A", p.9)

The Ninth Circuit next considered the question "whether section 93 of the National Bank Act restricts our ability to consider the section 10(b) claims." Appendix "A", p. 10. The Court correctly concluded it does not.

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[3]Interestingly, C. Arnholt Smith, the one defendant directly affected by the National Bank Act and thus the one person primarily concerned with the inter-relationship between that Act and the federal securities laws, has not petitioned this Court for relief.

The Court reasoned that allowing a section 10(b) claim would not subject bank directors to varying standards of liability from state to state, the concern in *Yates*. Nor did Congress exclude banks from the coverage of section 10(b), although it did provide specific exemptions for banks from other provisions of the securities laws. Because there is no conflict between the two statutes, statutory construction requires that each be regarded as effective. *Morton v. Manchri*, 417 U.S. 535, 551 (1974). Finally, this Court's decision in *Radzanower v. Touche, Ross & Co.*, 426 U.S. 148 (1976) is consistent with the conclusion that the federal securities laws do apply to national banks.

Petitioners cite to no decisions, by this Court or by other circuits, which suggest that securities claims against bank directors are foreclosed by the existence of the National Bank Act. Rather, they merely attempt to graft the "exclusivity" language applicable only to pendent common law claims under *Yates*, on to the separate body of federal securities laws. As the Ninth Circuit determined, petitioners' position is inconsistent with prior case law. Moreover, the ultimate result of Petitioner's argument would be to read § 10(b) out of the statute books in any case involving bank securities. Under this reasoning, if any bank director is liable under Section 93 of the National Bank Act, then *no one else* can be held for responsible for aiding and abetting or conspiracy to violate § 10(b). In particular, Carol Shannon and Phil Toft would be immune from suit, no matter how egregious their conduct, so long as C.A. Smith violated the National Bank Act. Such a result is preposterous.

The Ninth Circuit harmonized the statutes and avoided the inherently untenable conclusion urged by petitioners. Nothing in the decision is at odds with any decision of this Court or of other circuits. No review is necessary.

**B. The Ninth Circuit Properly Assessed the Class Certification and Standing Issues**

Petitioners Shannon and Toft argue here, as they argued in the Ninth Circuit, that the trial court's failure to certify a specific, formal purchaser subclass was improper; and further that plaintiffs lacked standing because they failed to prevail on the merits as to certain time periods. These arguments were properly rejected by the Ninth Circuit, and raise no issues meriting review by this Court.

**(1) Class Certification Does Not Require Review**

Petitioners argue that by allowing the class certified under § 93 of the National Bank Act to function simultaneously as the plaintiff class in the securities fraud claim, the trial judge in effect created a 10(b) class whose membership was broad enough to include actual shareholders, in addition to purchasers and sellers of USNB stock. Except for the bald assertion that this action demonstrated the trial court's lack of "regard . . . for the key language in § 10(b)" (Petition, p. 16), petitioners meticulously avoid stating their precise objection to the class delineation. In fact, an examination of the trial record demonstrates the court's ongoing adherence to the mandate of *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 729 (1975). As early as the Pretrial Order, the trial court carefully distinguished the issues to be addressed under the respective claims, noting that the principal question to be resolved

by members of the § 10(b) class was "(w)hether under Rule 10b-5 the alleged misrepresentations and omissions were made 'in connection with' the purchase or sale of USNB securities." (CR 1036). Later in instructing the jury on the 10(b) count, the trial judge explicitly noted that a requirement for finding liability was that "the defendants used the mails *in connection with the purchase or sale of securities.*" (RT 7081; Emphasis added). Finally, in his instructions at the conclusion of the damage phase, the trial court directed the jury that:

> The plaintiff is required to prove, by a fair preponderance of the evidence, that he or she suffered damages as a proximate result of the alleged misleading statements or missions, *and the purchase of stock in reliance on that.* (RT 9995; emphasis added)

Nothing in the trial record suggests that the handling of the 10(b) claims resulted in injury to the defendants' interests. While class members with 10(b) claims represented a well-defined sub-group of the class as certified, there was neither antagonism nor conflict between those class members and the National Bank Act "holders." The Ninth Circuit agreed, and specifically found:

> Given the district court's specific and unambiguous instructions to the jury that only purchasers of stock could recover, appellants did not suffer any prejudice because the trial court failed formally to certify a subclass of purchasers. (Appendix "A", p. 15)

**(2) Plaintiffs Below Had Standing to Sue Shannon and Toft**

**The sole basis for petitioners' claim that plaintiffs lacked standing to sue is that "Shannon and Toft's alleged liability was found by the jury to have started after the class rep-**

resentatives had purchased their stock." Petition, p. 17. This hindsight reasoning contradicts fundamental jurisdictional concepts.

The Ninth Circuit quite properly rejected this argument. See Appendix "A" to Petition, pp. 16-17:

> These plaintiffs had standing to pursue the action in the first instance. Standing ordinarily does not depend upon the merits of a plaintiff's contentions; the requirement is based upon a separate determination that the plaintiffs have made "allegations of demonstrable, particularlized injury." *Warth v. Seldin,* 422 U.S. 490, 508, 95 S.Ct. 2197, 2210 (1975).

There is no reason to review the Ninth Circuit's determination.

### C. The Ninth Circuit's Analysis of Secondary Liability Is Correct and Consistent with Prior Cases from This Court

Petitioners Shannon and Toft raise the same arguments concerning secondary liability under Section 10(b) as are raised in the petition for writ of certiorari filed by Helen Smith in this case (No. 82-1980). This Court is respectfully referred to respondents' Brief in Opposition to Helen Smith's petition, Section II (B), pp. 14-16.

In summary, the test applied by the Ninth Circuit was, if anything, more stringent than the Second Circuit standards outlined in *ITT, An International Investment Trust v. Cornfeld,* 619 F.2d 909, 922 (2d Cir. 1980). The Court found that Shannon and Toft had actual knowledge of C. Arnholt Smith's primary violations and of their roles in furthering them. The Ninth Circuit found the holding in *Chiarella v.*

*U.S.*, 445 U.S. 222 (1980) inapplicable, since the duty of a secondary violator arises from knowing assistance of or participation in a fraudulent scheme. The Court found as a fact that:

> The record clearly shows that the jury was presented with sufficient evidence surrounding transactions involving both Shannon and Toft from which it could find knowing assistance or participation. (Appendix "A", p. 17)

No review by this Court is required.

## CONCLUSION

The judgments against Shannon and Toft were fairly obtained and fairly reviewed. Nothing in the Ninth Circuit's opinion is contrary to prior decisions of this Court or of the other circuits. It is respectfully requested that the petition be denied.

Dated: July 6, 1983

Respectfully submitted,

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